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IMPACT OF TAX REFORM AND SIMPLIFICATION PROPOSALS ON SMALL BUSINESS

HEARINGS

BEFORE THE

COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

ON

IMPACT OF TAX REFORM AND SIMPLIFICATION PROPOSALS ON SMALL BUSINESS

Part 3

VANCOUVER, WA—AUGUST 16, 1985
SEATTLE, WA—AUGUST 19, 1985
FORT SMITH, AR—AUGUST 27, 1985
WEST MEMPHIS, AR—AUGUST 28, 1985

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CONTENTS

Statement of Senators: Page

Bumpers, Hon. Dale, a U.S. Senator from the State of Arkansas, and acting chairman, Committee on Small Business 935, 1007

Gorton, Hon. Slade, a U.S. Senator from the State of Washington, and acting chairman, Committee on Small Business 731, 805

Statement of:

Alkire, Durwood L., professor of accounting, School of Business, University of Washington, Seattle, WA 806

Battles, Millard T., III, Tourist Regional Information Program of Southwest Washington, Longview, WA 732

Beeksma, B. R., president, Interwest Savings Banks, Oak Harbor, WA 825

Bledsoe, Stewart, executive director, Washington Forest Protection Association, Olympia WA 774

Brawley, Don W., special agent, Prudential Insurance Co., West Memphis, AR 1033

Brazier, Nona, president, Northwest Recovery Systems, Inc., Federal Way, WA 897

Brown, Sharon, owner, Brown's Grocery Store, West Memphis, AR 1026

Butler, Don, president-elect, Arkansas Home Builders Association, Little Rock, AR 1020

Byars, Joe D., BHC Life & Group Specialists, Inc 976

Byrd, William F., III, president, Pacific Die Casting Corp., Vancouver, WA 797

Byrne, Jim, director of governmental affairs, Washington Credit Union League 884

Cary, Victor, the Wortz Co 964

Chace, Robert A., certified public accountant, Longview, WA 740

Chitman, Hon. Leo, mayor, West Memphis, AR 1008

Christianson, Ken, president, Alf. Christianson Seed Co., Mount Vernon, WA 915

Crissey, Sten, president, Crissey Flowers & Gifts, Seattle, WA 921

Dodge, Harry F., certified public accountant, Dodge, Thomas & Goss, West Memphis, AR 1032

Dooley, Joe, John Deere equipment dealer, Wynne, AR, representing the Mid-South Farm Equipment Association 1040

DuJardin, Dave, DuJardin Development, Everett, WA 913

Duzan, Stephan A., president, Immunex Corp., Seattle, WA 889

Erickson, Vinton, Vancouver, WA 784

Ford, Michael E., president, West Memphis Board of Realtors, West Memphis, AR 1019

Gordon, John F., executive vice president, Restaurant Association of the State of Washington, Seattle, WA 906

Hanson, Nels, president, Washington Farm Forestry Association, Olympia, WA 767

Hatfield, Dick, tax attorney, Hatfield, Hodges, Marshall & Jordan, West Memphis, AR 1029

Hughes, Paul C., president and chief executive officer, Farmers Soybean Corp., Blytheville, AR 1010

Johnson, Darlene G., president, Woodland Truck Line, Vancouver, WA 787

Lambert, Beverly, III, Merchants National Bank of Fort Smith 975

Lewis, Maurice, Arkansas Hospitality Association 938

Ludington, Samuel R., certified public accountant 954

Mariger, Randall, department of economics, University of Washington, Seattle, WA 814

McKnight, Donald, farmer, Parkin, AR 1011

Page

Statement of—Continued
Norton, Gaines, Frost & Co 951
Petersen, Bob, port manager, Ilwaco, WA 777
Price, John Porter, J. P. Price Lumber Co 988
Purtle, Ned Ray, Ned Purtle & Son 991
Sanders, Sandy, Whirlpool Corp 969
Schmidt, David, chairman of the board, Coulee Dam Credit Union, Coulee City, WA, on behalf of the Washington Credit Union League 883
Soule, Ray L., president, Great Northwest S&L Association, Bremerton, WA 828
Sperline, Elizabeth, president, ESSA International, Inc., Rochester, WA 754
Stephens, John, retired farmer, Marion, AR 1044
St. John, Bill, Bio Techniques Laboratories, Inc., Redmond, WA 887
Wise, Gordon M., Mamco Manufacturing, Seattle, WA 904
Young, Thomas C., Northwest National Bank, Vancouver, WA 752

HEARING DATES

August 16, 1985:
Morning session (Vancouver, WA) 731
August 19, 1985:
Afternoon session (Seattle, WA) 805
August 27, 1985:
Morning session (Fort Smith, AR) 935
August 28, 1985:
Morning session (West Memphis, AR) 1007

IMPACT OF TAX REFORM AND SIMPLIFICATION PROPOSALS ON SMALL BUSINESS

FRIDAY, AUGUST 16, 1985

U.S. SENATE,
COMMITTEE ON SMALL BUSINESS,
Vancouver, WA.

The committee met, pursuant to notice, at 9:15 a.m., at the Clark County PUD Building, Vancouver, WA, Hon. Slade Gorton (acting chairman of the committee) presiding.

Present: Senator Gorton.

STATEMENT OF HON. SLADE GORTON, A U.S. SENATOR FROM THE STATE OF WASHINGTON, AND ACTING CHAIRMAN, COMMITTEE ON SMALL BUSINESS

Senator GORTON. I want to welcome all of you today to this hearing on tax reform and small business; and in doing so, I want to elaborate on what we're going to do and what I'm trying to accomplish.

This is a formal hearing of the Senate Committee on Small Business, of which I'm a member. It's one of a series of hearings which have been held across the United States and it reflects the committee's concern about the impact which tax reform will have on small businesses.

The current Tax Code is a conglomeration of provisions characterized by loopholes, special breaks, and legitimate deductions which together form one of the most complicated mazes that businesses and individuals face. The cost of adhering to the code and of administering it is great, and it is growing. Therefore, the prospect of tax reform is encouraging, leading, I hope, to increased fairness, simplicity, and incentives.

But there is real cause for apprehension. The task of overhauling the Tax Code from stem to stern is a complicated one for many reasons, and there is no excuse for proceeding without looking at all of its implications. Uncertainties as to the effects of altering provisions of the Tax Code abound, indicating that we must proceed deliberately and cautiously. Moreover, there are industrial goals which Congress should incorporate in the code which further complicate the process. This is difficult because, while many of us in Congress agree that we want to retain or implement provisions that provide incentives to business, reaching a consensus about which incentives should be preserved or enhanced, how they should be implemented, and who should benefit is extremely difficult.

Finally, pressure from powerful interest groups and lobbies, each with its own agenda, threatens to impede progress towards achieving fairness in the code. These factors, in addition to the sheer magnitude and complexity of the task, make tax reform unpredictable, although it is still achievable, and may prevent Congress from fully attaining its objectives.

Bearing these sobering thoughts in mind, we must proceed with our investigation of the various tax reform proposals. Since the President's package will be the starting point for congressional debate and is the most comprehensive one, we will focus our discussion on it, although there are other issues we may want to discuss as well. This investigation is an important exercise because it will bring to light what is of universal importance to small businesses and what is of importance to various industries of which small businesses are a part. Small businesses are vital to this economy and we must never underestimate the extent to which they generate jobs and innovation and contribute to our ability to compete overseas. We will not be successful in reforming the Tax Code if, in the process, we undermine the ability of small businesses to thrive and to contribute still more to our economy.

It is for these reasons that I have called these hearings on tax reform and small business. My purpose is to root out what is important to businesses in our State; and the two hearings we are holding, which consist of seven panels comprised of various small businesses and tax experts, will undoubtedly enlighten us.

And with that, we have three of the four people who are here for the first panel. I think that one mistook the time at which we were to start, so we will go through the three of you, and I hope that Ms. Sperline will be here before the panel has completed its tasks.

Simply arbitrarily, I'll start on my left with Mr. Battles.

STATEMENT OF MILLARD T. BATTLES III, TOURIST REGIONAL INFORMATION PROGRAM OF SOUTHWEST WASHINGTON, LONGVIEW, WA

Mr. **Battles**. Thank you very much, Senator Gorton, for giving me the opportunity to present this morning. The emphasis of my presentation today discusses the impact of the tourism industry as it relates to the taxation of small businesses in southwest Washington.

I am the executive director of the Tourist Regional Information Program of southwest Washington. This program is a cooperative effort between the State, local government, and the private sector of six counties, including Clark, Cowlitz, Lewis, Pacific, Skamania, and Wahkiakum, organized to help support the development and diversification of the tourism industry by providing information to the visitors of the region and to the tourism industry as a whole. It compiles various listings of attractions and services available for visitors. The purpose of the program is also to provide research and education to the tourism industry in southwest Washington. My comments today are not necessarily reflective of the board of directors of our program, nor of the membership or other agencies that support our program.

Unlike many industries in the Northwest, the tourism industry has been a "growth" industry in the recent years. Total tourism expenditures for 1984 showed at least a 5-percent increase over the 1983 level and be close to $2.9 billion. Employment in the peak summer period was estimated at 82,636 people, including seasonal and part-time employees, which is a gain of 3 percent over 1983 levels. Payroll totals were estimated to be about $630 million, or a 4-percent increase.

The State economy is expected to show gains in 1985, although at a slower rate than 1984. The State tourism development division estimates expenditures to be $3.1 billion. Employment should reach 86,000 people with an approximate payroll of $645 million. Currently, tourism ranks as the third largest industry in the State.

In southwest Washington, travel expenditures were estimated at $80 million with a generated employment of 2,060 people and an estimated payroll of $15.2 million.

The reason why these economic figures are so important is due to the fact that 98.8 percent of the businesses that make up the tourism industry in the United States are defined as small businesses, which means those that employ less than 50 people. In southwest Washington alone more than 99 percent of the 167 lodging and camping facilities are small businesses. Although I have no figures for restaurants, most restaurants are also small businesses.

Any tax or regulatory policies that provide a negative effect on the small business—or a positive effect, for that matter—will also have a direct, immediate, and drastic impact on the tourism industry and on the many other secondary small businesses which support the industry.

The Treasury Department's proposal not to allow deductions on entertainment expenses and to further limit deductions for business and travel expenses discriminates directly against small businesses related to travel. In the tourism industry a small business person must work very closely with the rest of the community if they plan on staying in business very long. Many belong to chambers or visitor and convention bureaus; he or she must travel to shows, events, meetings, and—in many cases—suppliers because of them being so far away from the industry. The tourism industry doesn't necessarily happen right where the suppliers are; sometimes they have to do a lot of travel. In that case, a limit of deducting travel expenditures will encourage less participation in economic and tourism development organizations and possibly discourage cooperative growth vitally needed within the industry. It is a highly fragmented industry as it is.

Many travel-oriented businesses rely on the business traveler. A reduction of deducting travel expenses will encourage less travel and therefore less income in an industry that is becoming more important to this State's economy.

The Treasury Department's limit to deduct only the mortgage interest expense for a principal residence affects the ability to draw investors into high-risk tourism destination areas and has already pretty much destroyed the second home real estate industry. Some small businesses in the tourism industry, due to a high-risk nature, do rely on individual investors rather than bank financing. Any proposals currently submitted concerning interest expenses could adversely affect parts of the industry by discouraging passive investment.

Overall, if any of the proposed tax legislation has an adverse effect on small business it will have a devastating effect on the entire travel and tourism industry, especially in this State and in southwest Washington.

Thank you for your time. If there are any questions, I would be happy to answer them.

[The prepared statement of Mr. Battles follows:]

TESTIMONY ON TAX REFORM PROPOSALS ON SMALL BUSINESSES TO THE U.S. SENATE COMMITTEE ON SMALL BUSINESS.

Millard T. Battles III
Tourist Regional Information Program of Southwest Washington
P.O. Box 128, 1575 Broadway, Longview WA 98632
(206) 577-3321

Thank you for this opportunity to present this morning. The emphasis of my presentation today discusses the impact of the tourism industry as it relates to the taxation of small businesses in Southwest Washington.

I am the Executive Director of the Tourist Regional Information Program of Southwest Washington. This Program is a cooperative effort between the state, local government and the private sector of six counties, including Clark, Cowlitz, Lewis, Pacific, Skamania and Wahkiakum, organized to help support the development and diversification of the tourism industry by providing information to the visitors of the region and to the tourism industry. It compiles various listings of attractions and services available for visitors. The program also provides research and education on the tourism industry in Southwest Washington. My comments today do not necessarily reflect the opinion of the Tourist Regional Information Program's Board of Directors, Membership, or other agencys which support our program.

Unlike many industries in the northwest, the tourism industry has been a "growth" industry in the recent years. Total tourism expenditures for 1984 are expected to show at least a 5 percent increase over the 1983 level and be close to $2.9 billion. Employment in the peak summer period was estimated at 82,636 including seasonal and part-time employees which is a gain of 3 percent over 1983 levels. Payroll totals were estimated to be $630 million or a 4 percent increase.

The state economy is expected to show gains in 1985, although at a slower rate than 1984. The State Tourism Development Division estimates expenditures to be $3.1 Billion. Employment should reach 86,000 people with an approximate payroll of $645 million.

Currently, Tourism ranks as the third largest industry in the state.

In Southwest Washington, travel expenditures were estimated at $80 million with a generated employment of 2,060 people and a $15.2 payroll.

The reason why these economic figures are so important is due to the fact that 98.8 percent of the businesses that make up the tourism industry in the United States are defined as small businesses (which means those that employ 50 or less people). In Southwest Washington alone more than 99% of the 167 lodging and camping facilities are small businesses. Although I have no figures, most restaurants are also small businesses.

Any tax or regulatory policies that provide a negative effect on the small business will also have a direct, immediate and drastic impact on the tourism industry and on the many other secondary small businesses which support the industry.

Although a simplification of the tax code looks appealing to the sole proprietor of a hotel, campground, gift store, or restaurant, the proposed legislation as a whole may have a negative impact on the tourism industry.

The Treasury Department's proposal not to allow deductions on entertainment expenses and to further limit deductions for business and travel expenses discriminates directly against small businesses related to travel.

In the tourism industry a small business person must work very closely with the rest of the community if they plan on staying in business very long. Many belong to Chambers or Visitor and Convention Bureaus. He or She must travel to shows, events, meetings, and in many cases suppliers. A limit of deducting travel expenditures will encourage less participation in economic and tourism development organizations and therefore discourage cooperative growth vitally needed within the industry.

Many travel oriented businesses rely on the business traveler. A reduction of deducting travel expenses will encourage less travel and therefore less income in an industry that is becoming more important to this states economy.

The Treasury Department's limit to deduct only the mortgage interest expense for a principal residence affects the ability to draw investors into high risk tourism destination areas and has already pretty much destroyed the second home real estate industry. Some small businesses in the tourism industry, due to a high risk nature, do rely on individual investors, rather than bank financing. Any proposals currently submitted concerning interest expenses could adversely affect parts of the industry by discouraging passive investment.

Overall, If any of the proposed tax legislation has an adverse effect on small business it will have a devastating effect on the entire travel and tourism industry, especially in this state and in Southwest Washington.

FIGURE 1

ECONOMIC IMPACT OF TOURISM
1983-1984
Washington State

	1983	1984* (Est.)	% Change
EXPENDITURES[1] ($ millions)	2,754	2,891	+ 5
EMPLOYMENT[2]	80,230	82,636	+ 3
PAYROLL[2] ($ millions)	608.5	630.1	+ 4
STATE TAXES[1] ($ millions)	119.4	125.3	+ 7
LOCAL HOTEL TAX ($ millions) DISBURSEMENTS[1]	6.476	6.795	+ 4

*These are all preliminary estimates based on data provided by different agencies and adjusted in accordance with formulas developed by the U.S. Travel Data Center for travel-dependent businesses.

Sources

[1] Washington State Department of Revenue

[2] Washington State Department of Employment Security (Peak Summer Season)

DT:8.20/14

FIGURE 3

TRAVEL GENERATED EXPENDITURES
1979-1984 (est.)
Washington State

	$ MILLIONS					
	1979	1980	1981	1982	1983	1984 (est.)
Public Transport	457	542	613	623	682	720
Auto Transport	502	621	688	654	668	665
Lodging	202	214	217	231	255	265
Food	651	660	646	657	725	780
Entertainment and Recreation	207	205	198	203	227	245
Incidental Purchases	186	187	179	179	195	220
TOTAL	2,208	2,432	2,541	2,550	2,754	2,885

Sources: U.S. Travel Data Center.
Tourism Development Division

DT:8.20/15

IMPACT OF TRAVEL ON SOUTHWEST WASHINGTON
1983 ESTIMATION

TRAVEL EXPENDITURES	$80,020,000.00
TRAVEL-GENERATED PAYROLL	$15,203,000.00
TRAVEL-GENERATED EMPLOYMENT	2,060 PEOPLE
STATE TAX RECEIPTS	$3,860,000.00
LOCAL TAX RECEIPTS	$1,098,000.00

These figures are based on total revenues for 1983, as provided by the State Department of Commerce and Economic Development.

Source: U.S. Travel Data Center, Washington, D.C.

DT:80/178
Tourism Development Division
Department of Commerce and Economic Development
December, 1984

Senator GORTON. Thank you, Mr. Battles. We'll get back to you with those when we've heard from the other witnesses.

Mr. Chace.

STATEMENT OF ROBERT A. CHACE, CERTIFIED PUBLIC ACCOUNTANT, LONGVIEW, WA

Mr. CHACE. I relish the opportunity to present my testimony before this committee. My testimony is centered on the tax aspects and how they would affect the small business.

Senator GORTON. We have your written testimony; it will be included in the record as if read. If you will give us the salient points here, I would appreciate it.

Mr. CHACE. Thank you very much.

In my oral testimony I want to center on the capital formation or the raising of capital by the small businessman and how the proposals by the President affect that ability. In my written presentation I do talk about the proposed corporate tax rates, the investment tax credit, and the depreciation proposals; and I think that when you talk about a small businessman trying to raise capital, you have to put those all into one bucket and take a look at those as a group.

The President's tax proposal decreased the corporate income tax rates and, as a reason for that, they eliminated the investment tax credit. So they've gotten rid of the investment tax credit in their proposal, but decreased the corporate tax rates as an offset. In addition, they changed the depreciation method—or they are proposing to change the depreciation methods—to extend the life of the assets over which they can be written off for two reasons. First, to make the lives more realistic than the lives under the present ACRS rules, and second, is that they attempted to take into effect the elimination of the investment tax credit.

I feel this, as a group, hurts the small businessman in that it actually increases his tax load. For instance, a small businessman just emerging or in a growth format would be increasing his property that normally would be subject to the investment tax credit and the depreciation. And as a result, or as a method for getting funds for acquiring these assets, he's either going to have to go to a financial institution or joint venture or to some outside source. The outside source probably is going to be looking to how much the small businessman makes on the investment of the acquisitions that he anticipates making and how much money he's going to make on his growth pattern. The joint venture would want to share in this. The financial institution would want to make sure it's going to make enough money to pay back the loan and the interest rates that they're going to charge.

The change in the tax rates under the President's proposal, the elimination of the investment tax credit and extension of the depreciation would not affect a very large corporation as much as it would a small businessman. For example, a small businessman who invests $150,000 in some kind of equipment would normally get 8 percent of that, or about $12,000, investment tax credit. That would offset all or a good portion of his income tax should he make $50,000 or less on his business in that year. And this tax break is something that the small businessman would look to in the initial stages of his business so he could continue to grow, and these are the years in which he is going to need that help in order to make sure that his corporation or his business succeeds.

There are other parts of the tax proposal that affect the ability of a small businessman to raise capital. The small businessman normally—or more frequently, now—is in the service business as opposed to the capital-intensive business. The proposal eliminates the cash basis of accounting except in some circumstances. If a small businessman goes to a financial institution or goes to some outside source, the outside source or the financial institution will probably require him to present financial statements using the accrual method of accounting. Generally accepted accounting principles, in most cases, call for this type of presentation. And as a result of this, and if the financial institution requires quarterly, semiannual or annual financial statements prepared on this basis, the small businessman will be precluded under this proposal from using a cash basis of accounting. This would increase his tax cost; it would increase his accounting costs; he would have to set up new systems and new records and new ways for accounting under this more difficult and more complex method of accounting.

Another area that the small businessman has benefited in, in the past, is the issuance of what I call private-purpose governmental bonds. The interest on these bonds has generally been tax exempt. Southwest Washington, and particularly Clark County, has used this vehicle in attracting industry to the area, and I think a proposal to eliminate the exemption from tax on the interest on these bonds is going to hurt this area—the businesses in the Northwest—and also the small businessman who is looking for a possibility of raising capital through, maybe, industrial development bonds.

Finally, the installment sales provisions under the proposal require that someone, such as a dealer who normally sells his inventory on the installment method, report as income any proceeds from the securing of a loan if the installment obligations are used as the security for the loan. I think that this is going to hurt the small businessman as opposed to the larger corporations who also sell under the installment method. For example, a large corporation that would normally sell its goods on the installment method might be able to find some other vehicle other than using the installment obligations as security for a loan in raising capital. A small businessman, because of competition with the larger corporations, would still be required to sell under the installment method to meet competition but nevertheless may not have the ability to use other means to raise capital.

So I think that these areas are the areas that we should focus on. It hurts the small businessman and makes it more difficult for him to raise capital.

Thank you.

[The prepared statement of Mr. Chace follows:]

UNITED STATES SENATE
COMMITTEE ON SMALL BUSINESS

THE PRESIDENT'S TAX PROPOSALS
FOR FAIRNESS, GROWTH, AND SIMPLICITY

TESTIMONY ON THE EFFECTS OF THE PROPOSALS ON SMALL BUSINESSES AND NORTHWEST BUSINESSES

given by

Robert A. Chace
Certified Public Accountant
2450 Paradise Drive
Longview, Washington 98632

August 16, 1985

On May 29, 1985, the Administration proposed a far ranging list of tax law changes which were designed to transform the present Internal Revenue Code into one of fairness and simplicity and one encouraging economic growth. My testimony is to express my concerns about how these proposals effect small businesses and businesses located in the Northwest.

The following proposed tax law changes have a dramatic effect on business interests. The overall thrust of my comments are that the below listed proposals are unfair to small businesses, and create a burden upon them not equally shared by larger businesses. Some proposals foist unnecessary record keeping responsibilities on businesses resulting in small businesses not having adequate capabilities to cope with the requirements. Other proposals shift too much tax liability to small businesses which are struggling to meet competition. I will discuss these in detail in the order in which they appear in this list:

CAPITAL FORMATION
  - Corporate tax rates
  - Investment tax credits
  - New depreciation rules

REVENUE GENERATION
  - Cash basis of accounting
  - Bad debt reserve deduction

PERCEIVED ABUSES
- Business meals, entertainment and travel expenses
- Installment sales

OTHER CHANGES
- Corporate dividend deduction
- Private Purpose state and municipal bonds
- Index inventories
- Limitation on interest expenses

CAPITAL FORMATION

The combination of maintaining the corporate tax rates at the lower end of the income level, the elimination of the investment tax credit, and the lengthening of the depreciation rates results in an overall increase in taxes for the small business. Often, a small business starting out on a road of growth faces many hurtles. One hurtle is the ability to accumulate enough capital with which to acquire assets either needed for the growth program or as a result of achieved growth. The present tax system allows for low tax rates on the amount of income likely to be earned by an emerging business. Furthermore, the investment tax credit has permitted the extra help needed for a capital intensive business. Shorter depreciation rates have provided a simple yet effective method of writing off assets most of which will become obsolete more quickly in an expanding company.

CORPORATE TAX RATES

The President's proposal for changing the corporate tax rates are in line with the idea of capital generation. This affords a new growth business the opportunity for a successful beginning. The following is a comparison of the current tax law, the original Treasury proposal, and the President's proposal.

INCOME BRACKET	CURRENT LAW	TREASURY'S PROPOSAL	PRESIDENT'S PROPOSAL
Up to $25,000	15%	33%	15%
$25,000 to $50,000	18%	33%	18%
$50,000 to $75,000	30%	33%	25%
$75,000 to $100,000	40%	33%	25%
over $100,000	46%	33%	25%(1)

(1) The graduated rates would be phased out for corporations with taxable income over $140,000, so that corporations with taxable income of $360,000 or more would pay a flat rate of 33%

I agree with retaining the current tax rates. While generous, the President's proposal takes into consideration the elimination of the investment tax credit. I am opposed to the repeal of the investment tax credit.

INVESTMENT TAX CREDITS

The elimination of the investment tax credit altogether will substantially deter the possible success of a new small business. In the early stages of development, a substantial amount of capital costs are incurred by a new business. The investment tax credit provides an incentive for acquiring business assets, and permits an extremely helpful reduction in the tax liability at a time when it is most needed.

I agree with elimination of investment tax credits in areas where investments are made simply to offset large tax liabilities. Examples are the rehabilitation tax credit and the energy credits.

As an alternative, I suggest a dollar limit on the investments qualifying for the investment tax credit such as now contained in the current law for used property.

NEW DEPRECIATION RULES

The President has proposed installing a new depreciation scheme called the Capital Cost Recovery System ("CCRS") which would replace the Accelerated Cost Recovery System ("ACRS").

Under the CCRS plan, all depreciable property will be assigned to six new classes all of which designate different rates of depreciation. The cost of the CCRS property will be adjusted for yearly inflation. The proposal contains complex rules governing when an how much of an adjustment is made in the year in which an asset is retired and sold or otherwise disposed of. Finally, the proposal suggests the Treasury Department "establish permanent facilities to conduct" empirical studies of economic depreciation."

My feeling about this proposal is that it complicates the concept of depreciation, and results in businesses wallowing in regulations upon regulations trying to determine the correct amount of depreciation to deduct. To me the rules for depreciation have been studied, written, rewritten and rethought too many times in the recent past. A new set of rules now will not provide any more accurate picture of the correct amount of depreciation than the rules of the past, nor will they help offset the repeal of the investment tax credit.

Businesses are now faced with many different depreciation methods all of which must be used for complying with the presentation of financial data. A business may be faced with computing depreciation using, at least, three different methods:

- Financial Statement presentation in accordance with generally accepted accounting principles;
- Federal income tax purposes (pre-ACRS, ACRS and now CCRS); and
- State income tax purposes (with a possibility of more than one state involved).

I suggest keeping the current ACRS depreciation rules in tact, but adjust the rates to longer lives, if needed. This would provide the stability needed for compliance with the current rules, and would not further complicate the depreciation systems being used.

REVENUE GENERATION

The changing of accounting methods from the cash basis, and the elimination of the bad debt reserve methods can be viewed as simply a way of generating addition revenue for the government. These proposals are unfair for small business, since it would require a change to a more complicated accounting method, and would prevent a deduction for credit losses contained in the portfolio of receivables.

CASH BASIS OF ACCOUNTING

The changes do not permit the use of the "cash method of accounting" unless two tests are met:

1. the average annual gross receipts of the business is $5 million or less; and
2. no other accounting method has been used regularly for purposes of reports to shareholders, partners, beneficiaries, or for credit purposes.

The "cash method of accounting" has been used in the past, because it is simple to use and the computation of taxable income is more definite. However, this method allows a taxpayer to eliminate all revenues until the cash has been received . On the other hand, expenses are not deductible until they are actually paid. The cash method is not available for those taxpayers maintaining an inventory of goods for sale.

In contrast, the accrual method requires the reporting of revenues when a sale is made regardless of when the cash is received. Under the accrual method, expenses are deductible when they are incurred regardless of when they are paid.

This proposal is over restrictive in that small businesses would be faced with changing their accounting methods when they apply for credit. In most instances, financial institutions require financial statements prepared on the accrual method. And, in most cases, generally accepted accounting principles require accrual methods to be used. Therefore, this law could eliminate altogether the use of the cash method of accounting. This would increase the cost of borrowing, and complicate accounting records for the very small businesses.

This proposal would have a major impact on service providers such as law firms, accounting firms, consulting engineering firms, architects, and other consulting firms. These firms are generally not paid in the same month in which the services are provided, but at some later date. This is in contrast to an employee who is generally paid shortly after his services are provided to his employer. This proposal discriminates against the owners of these service organizations.

This proposal also discriminates against those wishing to form partnerships by, in effect, forcing them to adopt the accrual method. The individual partners would be forced into the accrual method because of the pass through of the income to their individual tax returns from the partnership.

Because of the complicated aspects of this proposal, and the unfairness to small businesses, I believe this proposal should be rejected.

BAD DEBT RESERVE DEDUCTION

The proposal repeals the allowance of a deduction for anticipated bad debts. Under the current law, a business is permitted to deduct the addition to a reserve for bad debts. In measuring the amount of the addition to the reserve, a taxpayer evaluates the current receivables, and from this evaluation decides a reasonable amount of the reserve.

The explanation for the change states that the calculated deduction does not take into consideration "... any discount for the present value of the ... losses ..." and the "... formula used to estimate such losses bears no necessary relationship to the future losses."

From our prospective, since the receivable, which will become bad, has been reported in the current year as taxable income, the deduction under the current rules is matched dollar for dollar with the timing of the income. Furthermore, the well established formula under the Black Motor Car case, in fact, does provide for a reasonable relationship to the losses already contained in the business receivables, but unidentified.

I believe the proposal is unfair in that it requires the reporting of income when a customer has made a purchase, but denies a deduction for a credit loss when they occur.

PERCEIVED ABUSES

BUSINESS MEALS, ENTERTAINMENT AND TRAVEL EXPENSES

Business meal deductions are proposed to be limited to those furnished in a clear business setting. If a business meal exceeds $25 per meal, only 50% of the excess will be deductible.

For example, if four people spend $30 each for a restaurant meal, the deductible portion is $27.50.

The proposal mandates additional detailed recordkeeping, in order to justify a business deduction. The cost of each meal must be recorded, and the limitation must be computed in each instance.

Furthermore, the limitations are opposed by the general business deduction concept that all ordinary and necessary business expenses are deductible in arriving at the net income of a business enterprise.

The current rules provide detailed requirements and recordkeeping rules, which, if followed, would yield a fair and equitable business deduction. I feel the current rules are not enforced by the Internal Revenue Service. If the current rules were enforced, there would not be the perceived abuse which resulted in this proposal.

Entertainment expenses would be eliminated under the proposal. The main focus of this change is to eliminate the deduction of tickets to sporting events and other expenses such as the cost of fishing trips and county club dues.

The limitations are opposed by the general business deduction concept that all ordinary and necessary business expenses are deductible in arriving at the net income of a business enterprise.

I recommend no change be made to the deduction of entertainment expenses.

Travel expenses will no longer be deductible where:

1. the taxpayer is away from home for more than a year;
2. the travel is via ocean liner, cruise ship or other luxury water transportation;
3. a convention, seminar, or other business meeting is held on a cruise ship; and
4. the travel is for education.

This provision creates an extreme hardship for those who are required to continue their education to maintain their competence. Many of these continuing education requirements are mandated by law. Examples are teachers, lawyers, physicians, and certified public accountants. Often times, the courses needed for an effective continuing education program are not available in the local area, and requires travel to a distant location.

I recommend this proposal be modified to permit the deduction of travel expenses incurred for education purposes.

INSTALLMENT SALES

Generally, the proposal requires recognition of gain on a long term installment obligation, if the obligation is used as security for a loan. For a dealer who regularly sells on an installment basis, gain would be recognized in the year of borrowing to the extent the borrowing exceeded the tax cost of the property sold. For non-dealers, gain will be recognized in the amount equal to the gross profit percentage multiplied by the amount borrowed.

Exempted from these rules are installment obligations of a dealer where the obligation will be paid within one year, a revolving credit plan where charges will be paid in one year, a non-renewable installment obligation which requires payment within 90 days, and indebtedness owed to a financial institution which is secured by a general lien on all of the borrower's property.

The law and the ensuing regulations will have to be complex and judgmental in order to prevent taxpayers from circumventing this law. Regulations will have to deal with he question about what is meant by the term "general lien", and how to prevent loopholes from being developed.

In addition, this proposal makes it far more difficult for the small business owner to met competition where it is the industry practice to sell its products using the installment method. Larger organizations have more resources and capabilities of securing borrowed funds, but still avoid the provisions of this proposal.

I recommend eliminating this proposal since it provides a hardship on a small business, and it complicates the law instead of simplifying it.

OTHER CHANGES

CORPORATE DIVIDEND DEDUCTION

Under the proposal, a corporation will be permitted to deduct 10% of the dividends it pays to shareholders. The proposal contains complex rules designed to prohibit the dividend deduction applying to dividends resulting from income not bearing the full weight of the income tax. For example, tax preference income would not result in a dividend deduction if it were paid out. Also, liquidating dividends and distributions in redemption of stock will not qualify.

Highly complex rules are also included for dividends paid from one corporation to another. The effect of these rules is to permit only one 10% deduction for dividends paid out to shareholders who are not corporations.

The stated reasons for the change is to mitigate the effects of taxing twice the income earned by the corporation - once at the corporate level and again at the individual shareholder level.

The allowance of a small 10% deduction is a move in the direction to eliminate the double taxation problem. But, the complexity of the proposal along with interpretive regulations, consequential court cases and pronouncements (not to mention the recordkeeping needed to implement this rule), seem to make the proposal more trouble than its worth.

Except for large corporations, the administrative costs to account and keep track of the required "Qualified Dividend Account" does not make sense when read in conjunction with the proposal to eliminate the $100 dividend exclusion for individual taxpayers. The reason for the elimination of the $100 exclusion is that it does not provide a marginal incentive for investing, and it "... contributes to complexity ...by adding an extra line (and two entries) on the ... Form 1040." Its hard to imagine how much effort and how many additional lines this 10% dividends deduction will add to a corporate return.

I suggest expanding the amount of the deduction so that it is really worth the time and effort in accounting for the deduction. In addition, the expansion of the deduction will solve the current dilemma about payment of dividends by a small corporate owner. Short of that, I suggest a rejection of this complex and ineffective provision.

PRIVATE PURPOSE MUNICIPAL BONDS

Under the proposal, interest from State or local government obligations would be taxable, if more than 1% of the proceeds were used by a person other than the government. The use of the facility by a nongovernmental organization would result in the bonds used to finance the facility being taxable obligations.

State and local governments have used their exemption privilege to obtain funds for financing facilities to be used by businesses. These are used most often to attract businesses to communities. This vehicle is being used more often as a tool to alleviate the harshness of an economically devastated community. This use has been viewed for many years as a valid governmental function. The state of Washington and Clark County, in particular, anticipates the use of this vehicle to ensure its economic stability.

I feel this proposal will further hamper communities in enhancing their economic circumstances. The Northwest is particularity effected by this proposal in a time when the timber industry is declining and the aluminum industry is depressed. Northwest communities are attempting to attract new and different companies to take place of the declines of their traditional industries.

INDEX INVENTORIES

The proposal establishes yet another inventory valuation method - the indexed FIFO method. Year end inventories will be indexed by use of a "relatively simple" computational method. This index will be in some way coupled with the inflation factor.

While this provision is somewhat of relief for those businesses holding appreciating inventories, we anticipate complex rules to handle conversion to this method, changes from this method, liquidation of inventories (such as a sale of a business), perceived abuses resulting from creative application of the law, etc. The matching of inventory costs with sales can readily be handled by the LIFO inventory method, if so chosen.

Another inventory method makes the law more complex, and would permit tax avoidance for businesses having the resources to hire accountants to compute the three method options which would be available for valuing inventories. This discriminates against small businesses which lack the resources to make the comparisons.

For the above reasons, I recommend against passage of this proposal.

LIMITATION OF INTEREST DEDUCTIONS

Deductible interest expense would be limited to the total of:

1. $5,000;
2. the taxpayer's net investment income; and
3. interest expense on the taxpayer's residence to the extent the debt does not exceed the value of the home.

The interest subject to the interest deduction limitation includes:

1. all interest not incurred in a business;
2. taxpayer's share of S corporation interest (except where the taxpayer takes an active management roll in the corporation); and
3. taxpayer's share of a limited partnership's interest expense (but only if the taxpayer is a limited partner).

For this purpose, interest incurred to acquire and carry business rental property is considered business interest, and is not subject to the limitation.

This proposal is over restrictive. In some cases a taxpayer must pay a large amount of interest in one year. For example, a substantial income tax deficiency would result in a large interest charge by the Internal Revenue Service. It is conceivable the amount of the interest on the deficiency would exceed the limitation, resulting in an additional penalty for what is probably a legitimate controversy.

The proposal should include exemptions for extraordinary interest paid in one year. Furthermore, the limitation on the interest deduction limits the incentive passive investors have in the development of real estate.

CONCLUSION

These are the provisions on which I have focused, and which, I believe, have the most effect on small businesses. When considering the current proposals for tax change, please keep my views in mind.

I appreciate the opportunity to testify before the Committee on Small Business. Should you have any questions, or would like more clarification on any of the points I have discussed, I will be happy to provide further testimony.

Respectfully submitted,

Robert A. Chace

Robert A. Chace
Certified Public Accountant

Senator Gorton. Thank you, Mr. Chace.

Mr. Young.

STATEMENT OF THOMAS C. YOUNG, NORTHWEST NATIONAL BANK, VANCOUVER, WA

Mr. Young. I am the president of a small, local community bank and have been asked to address the specific implications of the proposed tax reform legislation as it applies to the community banks.

I applaud the intent of the President's proposal, Treasury II, to simplify the Tax Code and eliminate the underreporting of income. I believe the overwhelming majority of Americans are dissatisfied with the complexities and perceived inequities of our current tax system. Although there are a number of proposals that directly impact commercial banks, I will mention only four and focus my comments on only two.

They are, one, the elimination of the reserve method of accounting for bad debts; two, the denial of the deduction for interest incurred to carry tax-exempt obligations; three, the imposition of mandatory accrual accounting; and four, the revision of the accelerated cost recovery system and elimination of investment tax credit.

Briefly, the adoption of numbers three and four in their present form would have a substantial impact on financial institutions. Mandatory accrual accounting would disproportionately penalize commercial banks as cash accounting for tax purposes is utilized widely throughout our industry; that is particulary the case with community banks. Also, revision of the accelerated cost recovery system and the removal of the investment tax credit might well cripple not only commercial banks' leasing operations, but the leasing business in its entirety.

The remaining two proposed revisions appear to be particularly onerous. Elimination of the deduction for interest incurred to carry tax-exempt obligations would radically affect the tax-exempt obligations market. Acceptance of this provision in its proposed format would substantially diminish the attractiveness of tax-exempts to commercial banks, who currently own 40 percent of the entire market. As a result, a decrease in their effective yield would prompt commercial banks to seek other, more profitable investments unless a comparable effective yield could be obtained on tax-exempt obligations. Hence, it seems logical to anticipate that as demand for State and municipal obligations declines, it would be forced to offer progressively higher rates to attract investors. The population of each of those States and municipalities would be forced to bear the increase in the cost of new offerings.

As well, existing bondholders might feel the immediate effects of diminished values of their holdings. Existing obligations will be grandfathered in; however, they will lose their exemption if sold. Obviously, this would substantially reduce their market value. Commercial banks might be able to carry their holdings to maturity, but individuals—who own 36 percent of outstanding tax exempts—might well be forced to liquidate their holdings at a significant loss prior to maturity.

The results of this proposed change are unpredictable and potentially very disruptive. At a minimum, it would seem appropriate to allow not only the holding of existing tax exempts without penalty, but the resale of those obligations without injury to the potential seller that invested in good faith under the prior Tax Code.

My final comments are reserved for what I consider the most ill-conceived element of the President's proposal. Presently, any corporation can create a bad debt reserve by allocating deductions as an expense item. Banks utilize one of two methods: either on a percentage, or an experience basis. The new proposal would require bad debts to be expensed only as they occur. Also, existing reserve accounts would be forced into income over the next 10 years.

This proposal seems contrary to the best interests of not only financial institutions, but the general public. Our industry has undergone tremendous changes in the last decade which have strained the stability of our entire banking system. We have witnessed a substantial increase in the number of small- and mid-sized bank failures and have seen the virtual bankruptcy of two major financial institutions. These problems are primarily the result of unanticipated difficulties in loan portfolios. As a result, it seems a singularly poor moment in time to disallow the maintenance of reserve accounts.

In recent years, bankers have pleaded the opposite side of this case as the regulatory authorities have continued to ask for increases in our reserve accounts. I, for one, do not perceive our reserve account as a tax-free repository for capital; rather, I view it as a prudent management tool to ensure the continued soundness of our bank. Recognizing losses only as incurred would be far more reasonable if they arrived in a consistent, recognizable pattern. Unfortunately, such is not the case. Their unpredictability could create substantial fluctuations in the operating results of a bank which might impact both stockholder and depositor confidence.

The logical alternative to this proposal might be to allow the regulatory authorities to set reserves based on their analysis of the quality of a bank's loan portfolio.

The compounding frustration is that generally accepted accounting principles, GAAP, are based on the accrual method of accounting. The reserve method is in accordance with GAAP. In other sections of the Treasury proposal, the cash method of accounting is limited in its application to certain classes of small taxpayers. The transition to the exclusive utilization of accrual accounting is totally inconsistent with the adoption of a pure cash method for recognizing bad debts. The inherent contradiction of simultaneously disallowing the cash method of accounting in general, while forcing the specific utilization of the singular application that works to our detriment, suggests the fundamental inequity of the proposed revision.

Thank you.

Senator GORTON. Ms. Sperline, we're ready for you up here at this last seat.

STATEMENT OF ELIZABETH SPERLINE, PRESIDENT, ESSA INTERNATIONAL, INC., ROCHESTER, WA

Ms. SPERLINE. My apologies for being late. I don't know how to get around this city.

I have your copy, Senator, and you have mine, so I will change with you.

Senator GORTON. All right.

Ms. SPERLINE. I am Elizabeth Sperline, and good morning.

Senator GORTON. Good morning.

Ms. SPERLINE. I'd like to thank you, first, for the opportunity to testify before the committee, and with that I'll go on with my prepared statement.

I am Elizabeth Sperline, president of ESSA International, Inc., a small business engaged in importing and marketing wines and spirits. I am also founder, officer, and director of Para Dynamics Corp., a manufacturer of computer mainframes and a computer system called Pronto. It's located in Scottsdale, AZ. For the record, I also own several other small businesses; in the past I have owned a machine shop, a printing company, a management consulting firm, a farm, and a ranch. So that puts me in a pretty broad base of small business.

Obviously, I believe in small business. It's been very good to me and my family and it's very good for this country.

I applaud President Reagan in his effort to find a method of taxing that is fair, simple, and allows for growth. I believe most Americans want such a system, a method to raise the revenue necessary to fund our Government. With that in mind, I will address those areas of the proposal which I think need to be retained, deleted, or revised.

Under methods of accounting, under present law a business is generally able to use the cash method of accounting if the business has no inventory. Income is taxable only when it is received. Deductions cannot be taken until actually paid. The accrual method requires taxation of income when the right to receive that income becomes fixed, although not necessarily received. Expenses are deducted in the year the fact and liability can be established or proven. Under the President's proposal, very few businesses would be able to use the cash method of accounting. A business would be forced to use the accrual method for taxes if, one, the business had any inventory; two, the business had annual gross receipts of $5 million or more; three, if the business had regularly used any other method of accounting to ascertain the income, profit or loss of the business for the purpose of reporting to stockholders or other partners; and for, for credit purposes. This probably is the most important to small businesses.

When a small business prepares a financial statement for the purpose of obtaining a loan, most often the lending institutions will not accept the cash method of accounting. Therefore, a business generally submits documents that have been prepared—usually by an accountant—using the accrual method. Under the proposal before us those companies, once having used the accrual method, would be forced to continue to use it for tax purposes thereafter.

For many of us who do have an inventory this isn't too much of a problem since we can't use the cash method anyway; but for small businesses that only keep small amounts of inventory on hand, such as my hair dresser or the dry cleaner, the accrual system presents an unfair burden. In addition, most owners would be forced to hire the accounting done by professionals as most don't have the expertise to do it themselves. Once again, small businesses would find themselves hiring someone just to handle the paperwork. This new person would not add one penny to the income of the business nor to the gross national product.

The elimination of the investment tax credit will be, in my opinion, the worst thing that could happen to small business. In an era when American businesses are faced with major international competition, I urge the administration and this committee to give strong consideration to retaining investment tax credits. We must continue to modernize American industry so we can compete in the world market. We cannot possibly pass along the costs of new plants and equipment to the consumer if we are to be competitive with foreign companies who are, for the most part, subsidized by their governments. Furthermore, the proposal as it stands today imposes retroactive taxes on companies which have already invested millions of dollars under the tax changes of 1981. I am not an attorney, but our Constitution clearly states we will have no ex post facto laws.

The costs to business of making investments in new equipment and plants will be further increased by the proposed Capital Cost Recovery System [CCRS]. Again, these costs cannot be passed on to the consumer if we are to compete against the largely-subsidized international competition. If we are not to retard economic growth, I urge the committee to carefully study this area of the proposal.

Expensing the cost of capital remains the most simple and honest method of writing off costs in business. I therefore recommend a tax system that allows expensing or its equivalent for all assets.

I am pleased to see the retention of section 179, which allows the expensing of up to $5,000 per year in business property. Small businesses should be encouraged to acquire property. It gives them an equity base on which to build and helps them become good citizen-neighbors.

I am also extremely pleased to see the restoration of a capital gains differential in the administration's proposal. On behalf of my clients over the last 15 years I have worked with many small business investment corporations and other venture capital groups. Based on my experiences with them I feel certain that the elimination of the capital gains rates would have resulted in a major loss of such capital inflow for startup businesses. Small business growth and expansion would be severely restricted. I congratulate the President on this restoration.

While we are in the area of investors there is another area of the tax reform proposal that will affect venture capital. The elimination of the State tax deduction on investment income will lower the after-tax return on investment. Investors will then demand higher before-tax returns. This will increase the cost of capital to all businesses, but the small, growing business will be the most vulnerable and, therefore, the hardest-hit.

I am a licensed realtor in another State. I also buy and sell real estate in the course of running my own business. The proposal before us today would lengthen depreciation schedules for real property, limit interest deductions for investors in many cases, and deny capital gains treatment for depreciable property. As an owner of rental properties I feel these restrictive measures may cause rents to be increased, construction of rental units to cease, and work a hardship on young families and senior citizens who rely on rental housing. I commend Congress for putting teeth into the 1984 tax laws to enable Treasury to capture a portion of the $13 billion of tax on profits in real estate made by foreign investors but not paid.

If business is forced to use the accrual system of accounting as proposed, the repeal of the bad debt reserve will be doubly unfair. It means we will be taxed on money we not only haven't received, but may never receive.

At first glance, one would think that repeal of income averaging is not a problem of business; however, many "kitchen table" and "mom and pop" businesses report their business income on their personal returns. These owners of unincorporated businesses face a greater likelihood of fluctuating income and would be most severely impacted.

Corporations still have the opportunity to carry losses forward and back. Again, if this is included in the tax reform package, I urge Congress to grandfather it in so that those businesses who have been "growing along" have an opportunity to, one, income average at least once. I am an entrepreneur and I can tell you that we are the proverbial optimists, and we tend to put off to next year because obviously, next year will be a better year to do it. And two, to convert their businesses to corporations within a specified time so that they may take advantage of the loss carryback and carryforward accounting systems or procedures.

On individual rate reduction, I cite a study made by the U.S. Chamber of Commerce which shows that the vast majority of small businesses are unincorporated at this time. I believe the reduction in rates for individuals will be a tremendous help to those business owners since the income is reported on their personal tax returns, as are the others I just touched on. Reduction in rates will allow more business expansion, more job openings, and more investment capital.

Graduated rates—I will only touch on graduated rates as it is too lengthy and complicated to try to cover in the time allocated to me at this hearing. I compliment the President for retaining the graduated rate schedule in his tax reform proposal.

For recommendations, in the last 6 years Congress has enacted four major tax bills resulting in 2,600 changes in tax laws. Small business is staggered by new reporting requirements, new regulations, and tons of paperwork. Just this year we saw an example of a paperwork burden placed on businesses regarding the keeping of auto use logs. American business rebelled. I am pleased to see that Congress repealed the law.

In the interests of keeping our businesses growing and not placing unfair burdens on them, I strongly urge Congress, when enacting new laws, to, one, give some leadtime to business so they may prepare for the necessary paperwork before the starting date of the legislation; two, grandfather in those laws, such as the investment tax credit, where business acted in good faith on new legislation and now stands to be penalized; three, when a tax reform or a tax law is enacted, that it carry a minimum of 5 years before it can be amended, but must be reviewed in its fourth year by Congress and recommendations sent to the appropriate committee. That will allow business to incorporate the law into their planning for at least 5 years without fear of the law being changed. And four, incorporate absolute and irrevocable sunset provisions into all tax laws enacted for special purposes.

Again, I thank you for the opportunity to present my views on some of the provisions of the most recent administration tax reform proposal. I wish to thank Senator Gorton and the Senate Committee on Small Business for their concern for small business. Small businesses provide more jobs than major corporations, contribute greatly to the tax base, and are the cornerstone of growth and prosperity for this country. And remember, large businesses. are just small businesses that grew.

Thank you.

[The prepared statement of Ms. Sperline follows:]

ESSA
International Inc.

STATEMENT OF
ELIZABETH SPERLINE
BEFORE THE
SENATE FIELD HEARING
OF THE
COMMITTEE ON SMALL BUSINESS
U.S. SENATE
AUGUST 16, 1985

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Senator Gorton and members of the commitee. Thank you for giving me this opportunity to testify before this committee today.

I am Elizabeth Sperline, President of ESSA International, Inc., a small business engaged in importing and marketing wines and spirits. I am also a founder, officer and director of Para Dynamics Corporation, a manufacturer of computor mainframes. Para Dynamics is located in Scottsdale, Arizona. For the record I also own several other businesses. Over the years I have owned a machine shop, a printing shop, a management consulting firm a ranch and a farm. I believe in small business. It has been good to me and it is good for this country.

I applaud President Reagan in his effort to find a method of taxing that is fair, simple and allows for growth. I believe most Americans want such a method to raise the revenue necessary to fund our Government. With that in mind, I will address those areas of the proposal which I think need to be retained, deleted or revised.

METHODS OF ACCOUNTING

Under present law a business is generally able to use the"cash method" of accounting if the business has no inventory. Income is taxable only when it is received. Deductions cannot be taken until actually paid. The accrual method requires taxation of income when the "right to receive" that income becomes fixed, although not necessarily received. Expenses are deducted in the year the fact and liability can be established or proven. Under the Presidents' proposal Very few businesses would be able to use the "cash method" of accounting. A business would be forced to use the accrual method for tax purposes if:

A. The business had any inventory

B. The business had annual gross receipts of five million dollars or more

C. If the business had regularly used any other method of accounting to ascertain the income, profit or loss of the business for the purpose of reporting to shareholders or partners.

D. For credit purposes. When a small business prepares a financial statement for the purpose of obtaining a loan, most often, the lending institutions will not accept the cash method of accounting, therefore a business generally submits documents prepared, usually by an accountant, using the accrual method. Under the proposal before us, those companies, once having used the accrual method, would be forced to continue to use it for tax purposes.

#2

For many of us who do have inventory this isn't too much of a burden since we can't use the cash method anyway, but for small businesses that only keep small amounts of inventory on hand such as my hair dresser, or the drycleaner, the accrual system presents an unfair burden. In addition, most owners would be forced to hire the accounting done by professionals as most don't have the expertise. Once again small businesses would find themselves hiring someone just to handle the paperwork. This new person would not add one penny to the income of the business, nor to the Gross National Product.

INVESTMENT TAX CREDIT

The elimination of the investment tax credit will be, in my estimation, the worse thing that could happen to small business.

In an era when American businesses are faced with major international competition, I urge the administration and this committee to give strong consideration to retaining investment tax credits. We must continue to modernize American industry so we can compete in the world market. We cannot possibly pass along the costs of new plants and equipment to the consumer if we are to be competitive with foreign companies who are for the most part subsidized by their governments. Furthermore, the proposal as it stands today, imposes retroactive taxes on companies which have already invested millions of dollars under the tax changes of 1981. I am not an attorney, but our Constitution clearly states we will have no expost facto laws.

CAPITAL COST RECOVERY SYSTEM

The costs to business of making investments in new equipment and plants will be further increased by the proposed "capital cost recovery system" (CCRS). Again these costs cannot be passed on to the consumer if we are to compete against the largely subsidized international competition. If we are not to retard economic growth, I urge the committee to carefully study this area of the proposal.

EXPENSING

Expensing the cost of capital remains the most simple and honest method of writing off costs in business. I therefore, recommend a tax system that allows expensing or its equivalent for all assets.

RETENTION OF179

I am pleased to see the retention of section 179 which allows the expensing of up to $5000.00 per year in business property. Small businesses should be encouraged to acquire property. It gives them an equity base on which to build and helps them become good citizen-neighbors.

CAPITAL GAINS DIFFERENTIAL

Iam also extremely pleased to see the restoration of a capital gains differential in the Administrations proposal. On behalf of my clients over the last 15 years I have worked with many Small Business Investment Corporations, and other venture capital groups. Based on my experiences with them, I feel certain that the elimination of the capital gains rates would have resulted in a major loss of such capital inflow for start-up businesses. Small business growth and expansion would be severly restricted. I congratulate the President on this restoration.

STATE TAX DEDUCTIONS

While we are in the area of investors there is another area of the tax reform proposal that will effect venture capital. The elimination of the state tax deduction on investment income will lower the after tax return on investment. Investors will then demand higher before-tax returns. This will increase the cost of capital to all businesses, but the small growing business will be the most vulnerable and therefore, the hardest hit.

REAL ESTATE

I am a licensed realtor in another state. I also buy and sell properties in the course of running my own business. The proposal before us today would lenghten depreciation schedules for real property, limit interest deductions for investors in many cases, and deny capital gains treatment for depreciable property.
As an owner of rental properties I feel these restrictive measures may cause rents to be increased, construction of rental units to cease and work a hardship on young families and senior citizens who rely on rental housing. I commend Congress for putting teeth into the 1984 tax laws to enable Treasury to capture a portion of the 13 billion dollars of tax on profits in real estate made by foreign investor but not paid.

REPEAL OF BAD DEBT RESERVE

If business is forced to use the accrual system of accounting as proposed, the repeal of the bad debt reserve will be doubly unfair, It means we will be taxed on money we not only haven't received, but on money we might never receive.

REPEAL OF INCOME AVERAGING

At first glance, one would think this is not a problem of business, however, many "kitchen table" and "mom and pop" businesses report their business income on their personal returns. These owners of unincorporated businesses face a greater likelyhood of fluctuating income and would be most severly impacted.

Corporations still have the opportunity to carry losses forward and back, again, if this is included in the tax reform package, I urge Congress to grandfather it in so that those businesses who have been "growing along" have an opportunity to;

1. Income average at least once. Owners of small businesses are to be proverbial optomists and tend to delay income averaging until next year.
2. To convert their businesses to corporations within a specified time so they may take advantage of the loss carry back and carry forward accounting procedures.

INDIVIDUAL RATE REDUCTION:

A study made by the U.S. chamber of commerce shows that the vast majority of small businesses are unincorporated at this time. I believe the reduction in rates for individuals will be a tremendous help to these business owners since the income is reported on their personal tax returns. Reductions in rates will allow more business expansion, new job openings and more investment capital.

GRADUATED RATES

I will only touch on graduated rates as it is too lenghty and complicated to try to cover in the balance of time allocated to me at this hearing. I compliment the President for retaining the graduated rate schedule in his tax reform proposal.

RECOMMENDATIONS

In the last six years Congress has enacted four major tax bills resulting in 2600 changes in the tax laws. Small business is staggered by new reporting requirements, new regulations and tons of paperwork. Just this year we saw an example of a paperwork burden placed on businesses regarding the keeping of auto use logs. American business rebelled. I am pleased to see that Congress repealed the law.

In the interest of keeping our businesses growing and not placing unfair burdens on them, I strongly urge Congress, when enacting new laws, to:

1. Give some lead time to business so they may prepare for the necessary paper work before the starting date of the legislation.
2. Grandfather in those laws such as the Investment tax credits, where business acted in good faith on new legislation and now stand to be penalized.

3. When a tax reform or tax law is enacted that it carry a minimum of 5 years before it can be amended, but must be reviewed in its fourth year by Congress and recommendations sent to the appropriate committee. That will allow business to incorporate the law into their planning for at least five years with out fear of finding the law changed.

4. Incorporate absolute and irrevocable sunset provisions into all tax laws enacted for special purposes.

CONCLUSION

Again, I thank you for the opportunity to present my views on some of the provisions of the most recent Administration tax reform proposal. I wish to thank Senator Gorton and the members of the Senate Committee on Small Business for their concern for small business. Small businesses provide more jobs than major corporations, contribute greatly to the tax base and are the cornerstone of growth and prosperity for this country. Remember, large businesses are just small businesses that grew.
THANK YOU.

Senator GORTON. Thank you, Ms. Sperline.

Mr. Battles, of the private sector members of your association or those whom you represent in the tourist industry, what percentage or share are corporations who are paying taxes, filing tax returns as corporations, subject to the corporate Tax Code?

Mr. BATTLES. Currently—this is just an estimate— but currently about 10 percent would have an association with a corporation. Many of our businesses are franchise where the actual management and ownership exists on the local level and is, in a sense, a small business. But for the most part, about 10 percent.

Senator GORTON. So the great bulk of these people are either operating as individuals or partnerships——

Mr. BATTLES. That's correct.

Senator GORTON [continuing]. Or subchapter S corporations, something of this sort?

Mr. BATTLES. That's correct.

Senator GORTON. As you know, the President's tax reform proposal lowers individual tax rates pretty much across the board from a maximum of 50 percent to a maximum of 35 percent. Would your members, by and large, propose or prefer Congress' passing the present tax reform proposal en toto, including the limitations on interest deductions, or rejecting it in total if that was their only alternative?

Mr. BATTLES. The businesses that I have talked to have not expressed their opinions directly to me. I would assume that, in general, the bottom line is that they would probably reject it as it is right now. But that is my opinion and an assumption on what I have been able to receive from them and not necessarily something that they have told me directly.

Senator GORTON. Is it your view that most of them would be more harmed by the loss of a second home interest deduction than they would be benefited by lower individual rates?

Mr. BATTLES. In that case, no. I would agree that, in that case, they would not be harmed. As a matter of fact, as it stands today, the second home industry has—and the second home deductions—

have already occurred where the industry is already pretty much gone as we knew it. And the tourism industry has been able to survive without it.

Senator GORTON. So the thrust of your testimony is that you would like some changes, but you still think——

Mr. BATTLES. Yes.

Senator GORTON [continuing]. That moving forward with tax reform in general terms is an appropriate course of action?

Mr. BATTLES. That would be correct.

Senator GORTON. Mr. Chace, in connection with your testimony, which is very well organized and very, very clearly outlined, it seems to me that it's not unfair to state that it goes to almost all of the proposed changes in the corporate Tax Code, which are included in the President's proposal. Is it your view in general terms that the present balance in revenue collections in the United States between individual tax collections and corporate tax collections is approximately correct, that there should not be a shift from tax burden on individuals to tax burden on corporations?

Mr. CHACE. Well, I think that's true. It's probably proportionately about where it ought to be now, but it should be kept in mind that individuals pay all the taxes one way or another, indirectly through a corporation or directly on their own tax returns.

Senator GORTON. Well, under those circumstances, should we simply repeal the corporate income tax?

Mr. CHACE. Well, I frankly think that corporations should be entitled to a very much larger amount of deductions for dividends paid the shareholders. Under the tax proposal now, the President is proposing to allow a 10 percent shareholder dividend deduction, and I think that creates more paperwork and more headaches than it really solves any problems. And I would think that they would want to eliminate that altogether or greatly enhance the amount of deductions at the corporate level.

Senator GORTON. So as far as you're concerned, the President's going in the wrong direction, to shift the tax burden from individuals to corporations? If anything, the shift should be in the other direction?

Mr. CHACE. Yes.

Senator GORTON. One presumes, given the present budget situation, that if we lower corporate taxes, we're going to have to increase individual taxes to make up for it—right?

Mr. CHACE. Well, that's true, you know, and it's sort of a revolutionary thing to eliminate all the corporate taxes that are being paid. I'm not suggesting that might be part of the proposal, but I certainly think it ought to be the direction that the law should go.

Senator GORTON. Do you think that there's any internal inconsistency or injustice in the present corporate tax burden? For example, is it appropriate that some corporations pay pretty close to the 46 percent maximum corporate tax and other quite highly profitable corporations, because of the legitimate use of many of the tax preferences which you've outlined here, should pay none at all?

Mr. CHACE. Well, I think a lot of the legitimate use of these tax deductions that corporations are now using were made available to them for a certain purpose. And we have to reinvestigate those purposes to find out if that's really something that the policy should be. I go back to my original thought, that maybe corporations shouldn't pay very much in the way of taxes. That's more of a philosophical thing, and how do you get individuals to increase all their taxes to make up for the corporations not paying any at all? I think that would be very difficult, if not impossible, to do. But I don't see any reason why large corporations shouldn't avoid tax if there is a reason for doing so; in other words, if there is a law that permits an exorbitant deduction, or something.

Senator GORTON. In any event, your answer to the question I asked Mr. Battles is very clear. If the only choice that Congress has is between the President's set of proposals or leaving the tax system alone entirely, you certainly would prefer us to leave it alone entirely?

Mr. CHACE. In these areas, yes.

Senator GORTON. But I'm saying in all areas.

Mr. CHACE. Oh, OK. Yes, I'd rather keep it the way it is because I really think—you know, they advertise that his proposals make the tax law more simple, and I don't think it does. You take a look at all these proposals, at least the ones I've outlined in my testimony, and almost all of them make it far more complicated—maybe not for the individual; it's centered on making it more simple for the individuals, maybe a tax return filing system that doesn't require people to fill out forms and mail them in. Things like that would be far more simple for the individual, but you take a look at almost all these proposals for corporations—far more complex, highly complex computations.

Senator GORTON. A question for both you and Mr. Young, since you both mentioned industrial development bonds, the tax-exempt nature of industrial development bonds. Isn't it quite obvious that the desirability of the purchase of such bonds—or, for that matter, all tax-exempt bonds—will be greatly reduced simply by the reduction of the maximum individual tax rate from 50 to 35 percent, without changing the nature of the bonds at all?

Mr. YOUNG. I would defer to Mr. Chace. I actually didn't mention them, and my expertise—we do not get involved with industrial development bonds.

Senator GORTON. Well, with tax exempts overall.

Mr. YOUNG. Uh huh.

Senator GORTON. The desirability of tax exempts overall is greatly reduced, is it not, by a reduction in the top individual tax rate?

Mr. YOUNG. I would certainly say that would be the case, yes.

Mr. CHACE. Well, that's true. You know, the person is not going to save that much more in tax, and the differential in the interest rates that is paid on exempt bonds versus taxable bonds is going to narrow because of the differential in the tax rates.

Senator GORTON. Which way will it narrow?

Mr. CHACE. Well, it will become closer.

Senator GORTON. I mean, which way will it narrow? Will it be exclusively that the interest rates on tax exempts go up, or will it be some increase in those interest rates and some decline in the rates on regular corporate bonds, for example?

Mr. CHACE. Well, you see, I don't deal that much in interest rates, so maybe I'll defer to Mr. Young.

Mr. **Young**. I wish I could speak to that question more intelligently, but one of my concerns is—I guess—I think it's an incredibly difficult question to answer because there are so many different market forces at work here, and where on one hand you can see forces that will be, perhaps, driving rates up, there perhaps can be other forces that can be driving rates down with, as you say, intangible factors. My concern is that—I'm not entirely opposed to the proposal. What concerns me is the proposal being effected in a very abrupt and immediate fashion. I think if it was—in fact, most of these proposals—if they were brought about over a fairly lengthy period of time in a moderated way that allowed the marketplace to accommodate for that change and for people to make realistic, long-term judgments without having to pay the penalty for having invested under prior Tax Codes and making personal investment decisions under prior tax codes, they were in fact given an opportunity to adjust to it, and banks, small businesses, individuals all had a chance to anticipate, "This is what's going to be happening over the next 5 to 10 years," and can make the appropriate adjustments.

Senator **Gorton**. Ms. Sperline, you, of course, made the same point. Unfortunately, Ms. Sperline, under the present Constitution of the United States there is no way that one Congress can anticipate what the next Congress is going to do. Would you agree, generally, with the philosophy that Mr. Young just gave us?

Ms. **Sperline**. I would just like to touch on the enterprise zones that the President has proposed. It seems like to me we would damage the mechanism to make that happen under the rules of the proposal. And I sort of wish this would be a worksheet that we were looking at instead of a proposal we had to either reject—or that you had to accept or reject.

Senator **Gorton**. Well, of course, we don't have to take it or reject it; in fact, at the end of the process, that isn't going to be our choice.

Ms. **Sperline**. Well, I thought I'd beat you to the punch because that's the option you gave all these guys. [Laughter.]

Senator **Gorton**. The problem is that I don't think there's a single concern that's been expressed by any one of you over a specific proposal taken in isolation that doesn't have a strong and forceful rationale behind it. Only Mr. Young has articulated the fact, however, that to restore each one of those incentives has a cost, and that cost is going to find its way into the individual budget; these incentives were established not so much arbitrarily, but with a desire to lower individual tax rates. And there's a very direct tradeoff between them, and I'm not sure where we're going to come out. That's why we're listening to all of you.

But maybe I'll come back to Mr. Chace, who had the broadest of all of the sets of rejections to the corporate tax changes, and make him make a flat choice.

Mr. Chace, if we were only going to make one major change in the President's proposal—install only one of these things which he proposes to take away from corporations—which is the most important point that you're making in your testimony?

Mr. **Chace**. I think it's with regard to the investment tax credit, combined with the corporate tax rates. For a small businessman, I would like to see that left alone. You may want to modify the availability of the investment credit like it is for used property; for example, put an upper limit on how much can qualify for the investment credit, even on new property. But I would like that part retained more than any other.

Senator GORTON. Ms. Sperline, do——

Ms. SPERLINE. I absolutely agree.

Senator GORTON [continuing]. Agree with that?

Ms. SPERLINE. Absolutely agree. The fact is, I think that would be the worst possible thing that could happen to small business.

Senator GORTON. OK. Thank you all. You've been very, very helpful, and I appreciate your willingness to testify today.

Mr. Hanson, Mr. Bledsoe, Mr. Petersen, and Mr. Marchand.

We will take you in the order that I called your names. Mr. Hanson, we will start with you.

STATEMENT OF NELS HANSON, PRESIDENT, WASHINGTON FARM FORESTRY ASSOCIATION, OLYMPIA, WA

Mr. HANSON. Senator Gorton and members of the Small Business Committee staff, I thank you for including us on your agenda today. I am president of the Washington Farm Forestry Association. It is an association of small timberland owners who grow timber as a crop. We don't own sawmills and plywood plants and all that, but we sell our logs to companies that do. There are about 40,000 small timberland owners in the State of Washington and they own, collectively, about 5 million acres of timberland, which is as much as that owned by all the big companies combined. So what they do on their land has a significant impact upon the volume of timber that's growing now and how much will be grown in the future.

So in speaking to the Treasury Department's tax reform proposal, I'll be addressing how its proposals might impact these small landowners, of which, incidentally, I'm one.

Senator GORTON. I didn't think your yard was that large, now. [Laughter.]

Mr. HANSON. The concept that's contained in the Treasury Department proposal that has gained by far the most attention is how it treats capital gains. But for the small timberland owner, that's way down the list in importance. The No. 1 concern is the ability to deduct expenses in the year they are incurred. By expenses I mean such things as interest on mortgages, interest on bank loans, taxes, timber stand management costs, like brush control and precommercial thinning and things of this nature. If these costs could not be deducted, the accrued costs for the 50 years it takes to grow the tree would far exceed the value of the timber. There would be no profit to treat as either capital gain or ordinary income.

The reason I say this can be illustrated by three different problems related to this proposal.

First of all, there is the discounted value of the dollar. Recognizing it takes about 50 years to grow a crop of timber, let's assume a landowner did plant some seedlings in 1983, and then in 1985 was faced with a brush control problem with alder and maple choking out the seedlings. A dollar spent for brush control in 1985 which could not be deducted until 2035 is no longer a dollar. When you "discount the value" of that dollar spent today by even 10 percent interest, you get to deduct a penny and a half in 2035. A dollar spent today is no longer worth a dollar 50 years from now.

The second thing affecting smaller landowners is changes in ownership, either due to sale or death. Keeping track of accrued costs when sold to another party would be difficult. If there were several ownerships over the life of the trees, the costs would never get deducted. But changes in ownership due to death creates even a greater problem. Recognizing that the person that plants the tree is seldom the person that harvests it; that is, unless you get a longevity clause into this tax reform proposal. [Laughter.]

But in its absence, and recognizing that when property changes hands from one generation to the next a new "cost-basis" is established. IRS does not deduct out the prior operating expenditures by the previous generation in transferring it to the next generation. So really, the deduction of expenses never would be made if the transfer went through an estate.

So it's for these three reasons: First, the discount value of a dollar you spend today, and what it's worth 50 years later; second, transfer of ownership through a sale from me to Mr. Bledsoe, for example, and my records being picked up by him would be unlikely; and three, transfers through an estate where the accrued costs would probably be lost.

So the deductibility of operating costs is the No. 1 concern of the small landowner. Now, going on to the second point, capital gains. Capital gains would be a moot issue unless we do have deductibility of expenditures.

The issue of capital gains assumes there is a profit in growing timber, which is difficult to prove sometimes today. Assuming that there would be a profit, the tax reform proposal discourages timber management. If I own a piece of land and I let it grow wild and some timber does grow on it, and I harvest the timber, then I could treat any profit as a capital gain. But if I "manage" the land and run it like a business, then I could no longer treat any profit on the sale of timber as capital gains,but must then treat it as ordinary income. So it would discourage small landowners from managing their timberland for a productive timber stand, because if they do, they will lose the benefit of capital gains treatment of any profit on it.

Now, the small landowners are of several types. For some, their timber is their sole income. There are many others that have other sources of income and they make expenditures on their tree farms as a discretionary investment that they don't need to make. They could put their money in a lot of other things if there was such unfavorable tax treatment for growing timber as is prescribed here in the Treasury Department proposal.

The Treasury Department proposal encourages any timberland owner to let things grow wild. In other words, it would revive the old practices that existed prior to 1944 when Congress adopted the present provisions of the Tax Code. We still hear about the cut-and-run practices which those previous tax policies created. The elimination of capital gains and the inability to deduct costs would bring back those cut-and-run practices again. And much of the land that has been so intensively reforested and well managed during the past 41 years would revert to an unmanaged status.

In summarizing, I believe our future supply of timber is really at stake. The manner in which small landowners manage the land will be influenced greatly by the tax package that comes out of Congress this biennium. We would certainly encourage two things. One is to continue deducting costs in the year they are incurred; and second, retain the capital gains treatment on any profit from the 50 year investment to grow that crop.

There's a third component under present law that helps small growers. Just as business can depreciate capital costs on equipment, timber owners can now amortize capital costs for reforestation, over a 7-year period. There is a maximum deduction of $10,000, so it applies to small landowners more than the corporate landowners. And we feel that this has been a real encouragement to invest in reforestation. It is third on our list of desirable features in the current Tax Code that we would like to see preserved.

I thank you.

[The prepared statement of Mr. Hanson follows:]

Washington Farm Forestry Association

110 WEST 26TH • OLYMPIA WA 98501 • TEL. 206 943 3875

TO The Honorable Slade Gorton, U. S. Senator
And Members of the U. S. Senate Small Business Committee

RE The Treasury Department Tax Reform Proposal

August 16, 1985

The Washington Farm Forestry Association is made up of people who own and operate family-size tree farms to grow timber as a crop. They own neither mills nor factories, but harvest their timber and sell their logs to larger companies that do.

There are about 40,000 of these smaller growers. They own as much of Washington's private timberland as that owned by all of the large companies combined. (About 5 million acres by each).

The proposed tax simplification bill now before Congress contains provisions which are a serious threat to these smaller growers. The announced objectives of "fairness and simplicity" seem to have been completely forgotten when it comes to those who manage their timber as a crop.

Since these smaller growers own half the private forest land in our state, the 40,000 individual decisions these families make will determine to a large degree the size of our future timber harvests for decades to come.

The two proposals which pose the greatest threat are

(1) the requirement to capitalize--rather than deduct--day-to-day operational costs and

(2) treating profits as "ordinary income" rather than "capital gain"

We fear that should Congress pass these proposals, the last remaining incentives for forest land owners to invest for the managed growth of this crop would be gone. Our Nation could become an importer rather than an exporter of forest products.

RECOMMENDED CHANGES

The members of our Association ask that two changes be made in the reform package so we are treated like other businesses;

1. That operating expenses continue to be deductible in the year the expense is incurred: (for such expense as interest on mortgages, interest on business loans; property taxes, protection from fire and disease, brush control, road and fence maintenance) The tax reform proposal would require that these day-to-day operating costs be accumulated for 50 years from reforestation until harvest (plus additional interest on these accrued costs). This creates a particularly heavy financial burden for smaller growers.

The larger timber growers who harvest every year could possibly charge each years expenses against timber

"A Crop Today . . . Another Tomorrow . . .
THROUGH GOOD FOREST MANAGEMENT"

harvested in that year. But: smaller growers who harvest once every 50 years--or even harvest part of their land every 20 years--would accrue interest costs and operating expenses far beyond the value of the harvest.

A operations dollar spent in 1985 is worth only a penny and a half in in 2035. At 10% interest, the discounted value of each dollar spent today would be almost a meaningless deduction when the crop is harvested 50 years from now.

Ownership changes occur periodically for smaller owners; either due to sale or death. Documentation of accumulated costs for reforestation and management through such ownership changes for half a century have a high probability for loss; and no one can deduct them.

The one who plants the tree seldom harvest it. The one who plants it seldom lives long enough. The costs incurred by one generation could not be passed on to the next. Estate taxes establish a new 'cost-basis' for the timber, but make no deductions for accrued operational costs. So they would never be deducted.

The proposed indexing for inflation adds further to complexity, particularly with changed ownership.

The objective of Simplicity in the tax reform proposal would instead bring more confusion and complexity for family-size tree farms whose accounting department often consists of a family member plus periodic consultation with professionals.

CAPITAL GAINS COULD BE A MOOT ISSUE. If the landowner were denied the option of deducting operating expenses in the year they are incurred, then the capital gain treatment of profits is a moot issue. The accumulated operating costs plus the accumulated interest on 100% of these costs would exceed the sale price of the timber so much that there would be no profit to report as either ordinary income or capital gain.

It is for this reason that the option to deduct operating costs is absolutely essential before the capital gains issue becomes relevant. Our second recommended change is

2. That profits be treated as capital gain rather than ordinary income

The tax reform proposal tells the landowner that if he or she manages the land for timber, then any profit will be treated as ordinary income.

On the other hand, if he or she just lets things grow wild, then any profit on timber that accidentally grows can be treated as a capital gain.

The tax reform proposal also allows a speculator who buys timberland, holds it the required time and then sells, to report any profit as capital gain. But the landowner who managed that same parcel of land to grow the timber, must report any profit as ordinary income.

The tax reform proposal would bring back the "cut-and-run" days of the thirties, when millions of acres were converted from timber to brush because tax policy at that time encouraged it.

In 1944, Congress changed that; Land owners could deduct operational expenses in the year incurred, and any profit on the 50 year investment was treated as capital gain.

Reforestation became worthwhile again, and millions of acres have since been restored.

However, if capital gains abuses have grown up over the years, we ask that rules to prevent abuses be adopted, rather than to throw out the concept altogether--as is contained in the tax reform proposal.

TIMBER SUPPLY AT STAKE

If Fairness and Simplicity were the objectives of the tax reform proposal, it certainly missed its target in the treatment of timber.

If Congress adopted this proposal, the damage to our timber supply would stretch for decades into the future. It would then take a half century after some future rule change before the harvest would again increase to current levels. The benefits of the 1944 changes are just now bringing their first harvest of forest products and jobs--40 years after the law was passed--.

OTHER TAX REFORM PROPOSALS

Those are the two most devastating proposals for small landowners in the tax reform proposal now before Congress.

There are other changes that are important to smaller landowners also. They are:

Under current law the owner can amortize reforestation investments over 7 years (like depreciating an investment for new equipment). We think its retention is an inducement to reforestation.

If capital investment for other businesses can be depreciated, then amortization should continue to apply to capital investment for reforestation.

The landowner is now eligible for a 10% investment credit for reforestation costs. If investment credit is taken away for other capital investment, then it should be taken away from growers also. But if it is retained for others, then it should continue for reforestation costs, also.

We understand a tax reform bill will soon be drafted. In behalf of the 40,000 small timberland owners in our state, we ask that you do everything possible to

1. retain the option to deduct operating expenses in the year they are incurred,

2. retain the capital gains treatment on any profits from investments in reforestation and the growing of timber; and

3. continue amortization of reforestation costs if depreciation is allowed for capital invested by other businesses.

The future supply of forest products and forest industry jobs depends upon the continued supply of timber. An adequate supply of timber requires reforestation and good management of our forest land.

The tax reform proposal would take away the economic incentives for the landowner to invest in that kind of management.

We ask that you do whatever is possible to retain a tax policy that encourages small land owners to do their part to maintain an adequate supply of forest products and jobs for the economic well-being of our state in the future.

Respectfully submitted,

Nels Hanson

Nels Hanson
President

Senator **Gorton**. Thank you very much.

Stewart, are you representing small businesses or big?

Mr. **Bledsoe**. Small business today, sir. [Laughter.]

Senator **Gorton**. Go ahead.

STATEMENT OF STEWART BLEDSOE, EXECUTIVE DIRECTOR, WASHINGTON FOREST PROTECTION ASSOCIATION, OLYMPIA, WA

Mr. **Bledsoe**. Good morning, Senator. My name is Stewart Bledsoe; I am the executive director of the Washington Forest Protection Association. I am speaking here at the request of the committee staff on behalf of the small business sector in Washington's forest products industry.

I'd like to comment on two things, time permitting, Senator. First, the effect of the tax reform proposal on the small business sector of the forest products industry; and second, an emerging profile of what our industry is going to look like in the forseeable future.

First, as manufacturers, we would be treated under the tax reform proposal as would any other processor of a natural resource commodity. Certainly, the testimony is replete with how that treatment would be accorded. Our hot button right now in the forest products industry, and particularly the small sector which is almost exclusively solid wood-oriented, is not tax reform. It's Federal deficits. We compliment and commend you, sir, in your efforts to try and do something about this urgent problem and wish that you had better luck.

Most of the special effects of the tax reform proposal will deal with the acquisition costs of our wood fiber. The small business sector in the forest products industry does not own their timberlands. It means that they must bid for the fiber flow on whatever market there is, either public sales or private sales; bid with Mr. Hanson's small-holders or anyplace that the fiber can be found.

In the short run, the effect of the tax reform proposal —should it pass in the form that we see it now—would constitute a vast disincentive for aggressive timberland management and also a major disincentive for continued ownership and maintenance in timber production of the land. There would be two effects, the short run and the long run, and they are dissimilar. In the short run the discouraging influence, the disincentive that the proposal represents will create a mindset in many of the landholders, "That's it." There will be a cut-and-get-out movement, which means that there will be a vast oversupply of unprocessed fiber on the market and a sharp depression in the stumpage prices. As a result, in the short run, we'll see a reduction in the acquisition costs for all forest products manufacturers, large and small alike.

The oversupply will also have a disastrous effect on a market that is only tenuously balanced now. The lumber market is characterized by an inelastic demand; and as we oversupply the market, by even a minimal percentage, we see a vast depression in price—two and three and sometimes four times the percentage of the oversupply. This short run oversupply could create a disaster throughout the market large and small, with a dumping of these unprecedented volumes because of cheap acquisition costs. You can ask the question, "Gee, that means that the price of the lands and the material will go down, and it will be a wonderful investment opportunity to buy those lands"——

Senator GORTON. Would it drive the Canadians out of our markets?

Mr. BLEDSOE. It's going to give them some bargain basement prices to compete against, there's no question about it. But what you must know, Senator, is that today in this State there are already 2 million acres of prime commercial forest land on the market with no takers. So I suggest that the only reaction can be a cut-and-get-out liquidation.

The national pattern, of course, will replicate that. In the geographically isolated Northwest; we'll have cheap acquisition costs but we'll still have our present competitive disadvantages—high transportation costs, high labor scale, and high regulatory costs. It's a push and shove situation; but in the short run, an aggravated disaster as the market is completely disoriented.

In the long run you will see, as a result of the original decisions, a diminished fiber flow. We'll downsize the industry here in the Pacific Northwest, certainly. We can only process what we grow; and once the inventory is gone and not replaced by reinvestment, that says the size of the farm is diminished. And we can only process what we grown, which means a downsized industry to do that.

In my estimation, without the expanded product lines, without the cash reserve, it will be the small operator who will be leading the casualty list as the processing industry down sizes. Lacking purchasing leverage, lacking economies of scale, and—with the Northwest selling into national and international markets—lacking marketing skills and contacts in many instances, the whole forest products industry will be stressed and the small business sector of it more highly than the other. And while there will be survivors—in the small business community—I think they'll probably be notable examples rather than consistent, full-scale members of the total profile.

Now, with your permission I'd like to talk about the emerging profile of the new industry because it's beginning to become perceptable. Throughout all of this later-day economic downturn, some outfits have consistently made money. There are enough of them now that you can qualify some strong similarities between these achiever/survivors. As you work the tax reform proposal in Congress, Senator, I would hope that you would keep these characteristics in mind simply because this emerging industry has some special qualities against which it's difficult to measure the tax reform proposal. And if you can keep this in mind as you do deal with it, I think it's going to be exceedingly important to the Pacific Northwest because we either emerge in this new profile across the board or we won't emerge.

First, the new restructured industry—the common denominator is not necessarily a factor of great size. As a matter of fact, the cutting edge of this thing emerged on the small business side, being emulated out of necessity by the industrial foresters as well. The new pattern is totally management-oriented from the CEO right down to the chap on the shipping dock. And everybody in the intervening stages sees themselves as a part of management, not an "us and them" category that has been so historical—almost suicidal—in our business. It's an involvement and interchange between the policymakers and the people who execute those policies. These onetime "outsiders" also see themselves involved in policy making for the only valid reason there they can be, and that is that they actually are.

Second, they are computer literate, and they are invariably state-of-the-art as far as their manufacturing facilities are concerned. All during the downturn they have aggressively made—even going into their own pocket and into some debt to do it—consistent improvements. Their plants are state-of-the-art: Laser-directed head rigs, computer-activated green chains; they're using brain and computer power instead of back power. Down sizing the work force to a degree, but in many instances paying more money to those who are performing the work because they are doing much more technical work and much more productive work. It's also interesting—in what used to be strictly a macho business, we hire many more women on the production line simply because the computer facilities, and so forth adapt themselves to the skills that many women possess in equal or greater quality than the men on the line.

The worker participation is exceedingly important. It's being done on two levels, some within the labor movement and some outside the labor movement. But in both cases, the approach is the same. The worker first identifies with the product, identifies with their own participation in the quality of the product, and it is also clearly identified in the benefits of increased productivity. Sharing, whether it's by wage scale contract or provision for revision at some future date, or whether it's actually built into the work program themselves, there is full participation. In the short run some hourly benefit reductions.

As a result, we have broken through on one of our big hangups here in the Pacific Northwest, which is the highest labor scale for forest products in the United States, in the world, that previously lacked a concomitant relationship to productivity. Productivity now is beginning to come forward. Also, as I mentioned, the profit-sharing—a totally new concept. My guess is one day you're going to see labor representatives on the board of directors of some of these firms if they're incorporated. These managers are innovative. They're working around high transportation costs. They're going around the Jones Act. They're barging. You can barge within the Jones Act, and they're towing oceangoing barges to California. They're setting up surge yards in Anaheim or Riverside or Phoenix so instead of the customer having to draw on a supplyyard in Everett or Bellingham, they draw on a supplyyard with their own trucks right there in the building area.

Going beyond that, and this is maybe the big distinction, they're almost exclusively sales-driven. Where we used to, as an industry, spend most of our money on production line—we had a bunch of drones over in the corner and we'd say, "We make 2 by 4's; go sell them." Not any more. We spend almost as much on sales. Large and small operations alike, the chap is on the phone daily to a customer he knows in Riverside, and he knows that the chap's son went to Cal Tech, so the conversation starts, "How did the finals go? Did Fred do OK?" "Yeah, he did fine." And then instead of saying, "We've got 2 by 4's 8 feet long; what'll you give us?" he said, "What do you want? What do you need?" "Well, we don't need anything—oh, yeah, we could use some 2 by 12's 14 inches—that's a bastard size. Instead of saying, "We don't make those," he says, "How many cars do you want? We'll make 'em for you". So he places the order, and then the order goes out to the woods, which is all set up to produce eight-foot multiples 16's or 32's. The woods boss gets the order for 28's and 56's, and says, "We don't do it that way. The truck bunks don't match that." "Then get new truck bunks." "Our truckers don't like that." "Then let's get new truckers, but we're making 14's this week."

So the thing is totally oriented to what the market wants rather than what the producer says the market wants, and these people are invariably successful. And that's the new look to the business.

As Congress deals with things like investment tax credits or depreciation schedules or the exempt status of industrial development bonds, I hope you can keep in mind the profile of this new industry taking shape here in the Northwest. It has some special needs because there is a high degree of risk here and it's still very fragile; we're far from solid recovery. But my guess is that within that profile, and without too much impediment at the governmental level, that we can make it, make the turnaround here.

End of comment.

Senator GORTON. Thank you.

Bob.

STATEMENT OF BOB PETERSEN, PORT MANAGER, ILWACO, WA

Mr. PETERSEN. Good morning, Senator. I appreciate very much being here. I'm Manager of the Port of Ilwaco, located in Pacific County. We are members of the Region Seven Tourism Association that Bud Battles spoke of here earlier.

Being a public port we do not pay income taxes ourselves, but the people who lease boat moorage and commercial property from us do. I've interviewed quite a few of them that are primarily engaged in recreational fishing and tourism, and the following is a resume of their comments.

Pierre Marchand, who is the President of Ilwaco Fish Company, had also intended to be here this morning, but the pressures of the fishing business and staying alive in it these days are such that he just, at the last minute, couldn't get here today. He has some very real concerns, though, and he's hoping to be able to express them in a letter to you. I talked to him about them and they're basically some of the capital problems that this bill would present, and he also has some thoughts on what he considers tax-related, anyway, regarding some proposed off-shore leasing of fisheries resources somewhat similar to those mineral resources. I don't know anything about that, but you'll probably be hearing something from him about that.

Of my remarks that I have prepared here, the first one that I have here is on entertainment expenses. A large share of our business at Ilwaco involves sports fishing. About half of the recreational fish caught at Ilwaco are caught from charter boats. Business entertainment accounts for about 40 percent of the charter boat business, plus many of the larger private boats in our harbor are owned by corporations and businesses and are used for entertaining. It's probably safe to estimate that about 50 percent of the dollars spent on recreational fishing are business entertainment-related.

The National Marine Fisheries Service estimates that the average ocean angler expenditure is $49.80 per trip. This figure does not include the cost of the boat or moorage or certain other expenses. In an average year—that is, before the recent hard times that we've been suffering—about 200,000 individual angling trips were made each year out of Ilwaco alone. That translates into about $5 million of business entertainment spending in our community, plus the moorage fees that are paid directly to the Port.

Currently, our business level is only about one-third of the previous average. The recent salmon treaty with Canada, the Regional Power Planning Act and other actions are bringing a turnaround in the numbers of fish that are available to be harvested. If we lost about half of our customers——

Senator GORTON. You're having a better season when I was last down here. [Laughter.]

Mr. PETERSEN. Thank God. We're struggling, but I guess it is a little bit better this year, thank you. We're still pretty nervous, but we're still alive.

But anyway, if we were to lose about half of our customers just about the time we're getting the fish back, we'd be right back behind the eight ball again anyway.

Another concern is on income averaging. The fishing business is full of peaks and valleys, mostly valleys lately, and the small business people that I talked to do take advantage of income averaging. If through a stroke of fortune they are able to make a profit this year, or some year, they would like to be able to average it out over several years.

Fringe benefits—these are something that both public and private employers provide for their employees. And on the face of it, it seems that the cost of these benefits—it would be reasonable to consider them to be taxable income. But upon my analysis, anyway, it seems that if an employee is to retain the same level of after-tax income and the same benefits, his pay would have to be increased by something more than the amount of the tax rate in order for his take-home pay to stay the same. This would be an additional cost of doing business for the private employer, and for the public employer it would result in either an additional burden on the taxpayers or on the ratepayers. It's got to be passed along somehow or another.

We realize that the current proposals would tax only a portion of these benefits, but we are concerned that this would represent a foot in the door and it would certainly not meet the goal of tax simplification—particularly for the employer who would have another whole set of calculations to go through to apportion out which is taxable income and which is not.

The whole subject of capital was an area of great concern to our people. Bob Chace, who spoke here earlier, was much more eloquent and knowledgeable on it than me, so I just would say that our people do share those same concerns. The one that was brought up most commonly was the Investment Tax Credit. Again, what I had prepared to say earlier, fishing is a marginal business; the ITC is a significant factor in decisionmaking when considering the purchase of things, such as a new fishing vessel. We have two-thirds of our harbor sitting empty; even though things are better this year we're still two-thirds empty, and if somebody is considering buying a new boat to moor in our harbor, we'd like for him to have all of the incentive that is reasonable to do so. Our people tell us that the Investment Tax Credit is very critical in their decisions concerning these things.

On industrial development bonds—and now I'm speaking on behalf of the Washington Public Ports Association, representing 59 Public Port Districts throughout the State of Washington—I want to express support for the continued availability of tax-exempt industrial development bonds as a necessary method of promoting job creation and overall economic development in our State. The capital made available through the existing IDB's is essential to the long-term economic health of Washington State, and particularly benefits smaller and new businesses with significant growth potential whose expansion is often stymied by prevailing high interest rates. Following passage by Congress of an act that significantly reduced the ability to issue IDB's, the association cooperated with other interested entities to develop a formula that preserves the ability to stimulate job creation. That formula was enacted into law by the 1985 Washington State Legislature. We request Congress impose no further reduction of IDB's until it is fully and clearly demonstrated that IDB's are contrary to the economic benefit of individual States and to the Nation as a whole.

In conclusion, I just want to state that we understand the proposals are intended to simplify tax reporting and to bring more equity into the system. We presume that the loss of certain current deductible expenses would be offset by lower tax rates. Most of the businesses in our area have not made a profit to pay taxes on in recent years, so all they see in the proposals is a loss of existing tax breaks.

As much as we agree that the tax system is in need of overhaul, we are concerned that the present proposals would result in more displacements than benefits. A better approach may be to go after the deductions and shelters that are being abused on an item-by-item basis, and at the same time retain the flexibility to give incentives to sectors of the economy that may need a boost from time to time.

[The prepared statement of Mr. Petersen follows:]

Testimony to be presented to the U.S. Senate Small Business
Committee, Senator Slade Gorton.
August 16, 1985

My name is Bob Petersen. I am Manager of the Port of Ilwaco, located in Pacific County. I appreciate this opportunity to comment on the proposed tax reform measures. Being a public Port we do not pay income taxes ourselves, but the people who lease boat moorage and commercial property from us do. I have interviewed many of them who are engaged in the recreational fishing business and the following is a resume of their comments.

Pierre Marchand, President of Ilwaco Fish Co., intended to testify here today from the perspective of the commercial fishing and processing interests. Those interests turned out to be so pressing that he just couldn't get away. He has some very real concerns though, which he will put in a letter to you.

ENTERTAINMENT EXPENSES

A large share of our business involves sports fishing. About half of the recreational fish caught at Ilwaco are from charter boats. Business entertainment accounts for 40% or more of the charter boat business, plus most of the larger private boats in our harbor are owned by corporations and used for entertaining. It is probably safe to estimate that 50% of the dollars spent on recreational fishing are business entertainment related.

The National Marine Fisheries Service estimates that the average ocean angler expenditure is $49.80 per trip. This figure does not include the cost of the boat, or moorage. In an average year--that is before the recent hard times we have been having--about 200,000 individual angler trips were made out of Ilwaco alone. That translates into about $5 million business entertainment spending in our community, plus the moorage fees paid directly to the Port.

Currently our business level is only about 1/3 of the previous average. The recent salmon treaty with Canada, the Regional Power Planning Act and other actions are bringing a turnaround in the number of fish available to be harvested. If we were to lose half of our customers just when we are getting the fish back we would be right back behind the Eight Ball again.

INCOME AVERAGING

The fishing business is full of peaks and valleys--mostly valleys lately. Most of the small business people I talked to do take advantage of income averaging. If though a stroke of good fortune they are able to turn a good profit one year they would hope to be able to average it out over several years.

FRINGE BENEFITS

Fringe benefits are something that both public and private employers provide for their employees. On the face of it, it seems that the cost of these benefits should be considered to be taxable income. Upon analysis though, if an employee is to retain the same level of after-tax income and the same benefits, his pay would have to be increased by more than the amount of the tax rate applicable to his wage bracket.

This would become an additional cost of doing business for private employers and for the public employers it would result in an additional burden on the taxpayers or ratepayers.

We realize that the current proposals would only tax a portion of the benefits, but we are concerned that this would only represent a foot in the door and it would certainly not meet the goal of tax simplification--particularly for the employer who would have another set of calculations to make to apportion the benefits into taxable and non-taxable portions.

INVESTMENT TAX CREDIT

Fishing is a marginal business these days. The ITC is a significant factor in decision making when considering purchase of things such as new fishing vessels. We have two-thirds of our harbor sitting empty and if someone is considering buying a boat to moor at our harbor we would like him to have all the incentive to do so that is reasonable. We understand that the investment tax credit is very critical to that decision.

DEPRECIATION

We understand that the proposals would result in a slower write off of assets. This would have a negative impact on our small businesses.

INDUSTRIAL DEVELOPMENT BONDS

Now, speaking on behalf of the Washington Public Ports Association, representing 59 Public Port Districts throughout the State of Washington, I want to express support for the continued availability of tax exempt industrial development bonds as a necessary method of promoting job creation and overall economic development in our state. The capital made available through the existing IDB's is essential to the long term economic health of Washington State, and particularly benefits smaller and new businesses with significant growth potential,whose expansion are often stymied by prevailing high interest rates. Following passage by Congress of an act that significantly reduced the ability to issue IDB's the Association cooperated with other interested entities to develop a formula that preserves the ability to stimulate job creation. That formula was enacted into law by the 1985 Legislature. We request Congress impose no further reduction of IDB's until it is fully and clearly demonstrated that IDB's are contrary to the economic benefit of individual states and to the nation as a whole.

CONCLUSION

We understand that the proposals are intended to simplify tax reporting and to bring more equity into the system. We presume that the loss of certain currently deductible expenses would be offset by lower tax rates. Most of the businesses in our area have not made a profit to pay taxes on in recent years though, so all they see in the proposals is a loss of existing tax breaks.

As much as we agree that the tax systems is in need of overhaul, we are concerned that the present proposals would result in more displacements than benefits. A better approach may be to go after the deductions and shelters that are being abused on an item by item basis, and at the same time retain the flexibility to give incentives to sectors of the economy that may need a boost from time to time.

Senator GORTON. Stewart, your outline of changes in the forest products industry, the way in which some companies and some people can be successful even in difficult times, is fascinating. It's certainly in accordance with what I've seen on some of the visits that I've made to a number of these places.

What I'd like to ask, however, because it's the subject matter of this hearing, is are those changes encouraged or inhibited by the present Tax Code? And to what extent would they be encouraged further or inhibited by changes in the Tax Code? Obviously they've been encouraged by bad times; they are the reaction—as long as anybody could make money whatever they were doing, there was no reason to come up with these changes. But let's just zero in on the present Tax Code and the proposed Tax Code.

Mr. BLEDSOE. I've asked that question of several of the operators, and I get mixed results. But the general substance is that it was done almost exclusive of the Tax Code. There were the provisions on capital gains treatment and the investment tax credit for some of the online modernization; those were incentives for making changes.

Senator GORTON. And the Accelerated Cost Recovery System?

Mr. BLEDSOE. That's correct. They were assisted, particularly where it was a marginal decision—"Are we going to be able to do it or not?" If it was very marginal, that could have been a factor and in many cases was a factor that tipped it forward. And that's one of the reason that I ask you to consider maintenance of those provisions for this new industry.

Now, with the new proposals I see that the negatives would force a down sizing of the industry itself. If that's the case, we're going to look at a replay of something like the ill-fated Donner Party. There were survivors from the Donner Party, but nobody was happy about the event. And I see something like that as being forced on the forest products industry in our geographic area as a result of the down play—specific negatives in the Treasury I and II proposals.

To anticipate, maybe, your next question, if you had to make your choice between having that and the upside individual tax reductions, we've measured that and the answer is that the downside is much worse with the specific reach-in effect of this thing——

Senator **Gorton**. Actually, my next question, Stewart, was whether or not you agreed with Nels Hanson as to the relative impact of the two principal proposals, the expensing versus capitalization as against capital gains. He was very eloquent that capital gains becomes irrelevant if you lose the other. Is that true for your clients? Is that true for the large companies?

Mr. **Bledsoe**. Not totally irrelevant, no. His order of priorities is correct. The ability to expense having such a tremendous effect on, one, cash-flow; two, management decisions that take you into long-range productivity. There's no question that that is of a superior priority. We're not quite as cavalier about the fact that capital gains could be gone and we would not miss it. There's no question about the fact that we would, because it also is part of the management coefficient. But his order of priorities is absolutely correct.

Senator **Gorton**. Nels, I take it that you agree with Stewart, that it is easy to choose the ultimate question. If you have to take the tax reform, even with lower rates and everything else, it is not worth the loss of these two preferences for the timber industry. If you have to choose no change at all or the changes proposed by the President unamended, you choose to live with the present tax law. Is that correct?

Mr. **Hanson**. Yes, Senator. The impact of these two items on growing timber would have a very negative effect on a landowner's decisions. There would be some 40,000 individual landowners making decisions. But when they weigh their options for the dollars that they normally invest in forest management, I think that would discourage forest investments. The other advantages, the lower rates, and the other components of the tax proposal— they would still share in those benefits; but the money that they now put in timber would be put into other investments.

Senator **Gorton**. Bob, do you agree, if your only choice is between the President's proposal and no changes at all? You would prefer to have no changes at all?

Mr. **Petersen**. Well, probably so, and just let me qualify that, because we're rather unsophisticated businesses down there; we don't have access to too many professional financial advisors. Our efforts have been almost exclusively spent in just staying alive, and any change is perceived as being a problem. People have learned to live with what they have, and without having the ability to make a thorough analysis of what the ultimate benefits might be. The feeling of the people there is basically what we have with minor revisions that take place from time to time. Inevitably—you know, when we hear about people that are making a million or more dollars a year and not paying any income tax at all, we think something is wrong. We don't know what they are doing to give them those benefits——

Senator **Gorton**. They're buying IDB's. [Laughter.]

Mr. **Petersen**. Well, in that case, maybe it's all right.

Senator **Gorton**. Stewart, do you think that the present balance between individual tax burdens and corporate tax burdens is about right?

Mr. **Bledsoe**. About right, yes. My feeling is that the move will be to place more on the corporate side; and within workable limits—and I'm not even going to suggest what those limits are—

it's probably survivable. If, on the other hand, it's a complete shift, then it could be disastrous because there is no magic in this business.

Senator GORTON. Thank you all very much. I really appreciate your help.

Mr. Erickson, Ms. Johnson, Mr. Byrd, and Mr. Ahl. Your name is first on the list, Mr. Erickson, and first alphabetically, so we're going to start with you.

STATEMENT OF VINTON ERICKSON, VANCOUVER, WA

Mr. ERICKSON. I'm Vinton Erickson, and I guess I'm considered a family farmer. I've been involved in this all my life, which seems to be like quite a while. [Laughter.]

I went over the list of things that we're supposed to talk about, taxes and so on, and I guess, bottom line, the farmer is having a rough time in business to try to stay in the black——

Senator GORTON. Tell me what you farm.

Mr. ERICKSON. Oh, yes, I meant to do that. Historically I guess I've been known for strawberries. I started raising strawberries in 1954 when I got out of the Army and have been with it ever since. We also have raised a lot of other crops over the years. One time I tried to have 10 crops and tried to gross $100,000 on each one to $1 million; and of course, the big advantage was crop rotation, proper use of people, equipment, and so on. I about reached that at one time. Right now we're raising strawberries, raspberries, sweet corn, and we raise grain——

Senator GORTON. You don't have a lot to do, then, with target prices and loan rates and so on? Most of your crops are not supported?

Mr. ERICKSON. That's true, we do not.

Senator GORTON. OK, go ahead.

Mr. ERICKSON. The other crops that we've got—we raise basically for processing or to a processor. We don't do our own. We do some fresh sales, some "U-pick-em" strawberries and things like that. Over the years we've raised a couple of hundred acres of broccoli per year, cauliflower, we've had a hundred acres of pole beans when that was the thing to be grazing; 3,000 ton of cabbage for sauerkraut, you know, for one of the processors; and we've raised generally 200 or 300 or 400 or 500 acres of grain. This last year grain was way down, so we're kind of out of it.

I guess one of the biggest things for the family farm, though, starting off bad is when the interest rates went up. I always said I would quit when it got to be 10 percent, and of course I had to eat those words quite a few times.

It seems to me like that—of course, interest rates being high—that commodity prices have not stayed in line with what we have to pay for. If we go out and buy a tractor—we used to buy a little tractor for $5,000; a little tractor today costs $20,000 or $30,000. Big tractors cost $60,000 to $100,000. Every time you buy a tool for it you pay $10,000 to $15,000, if you buy a plough or whatever you buy for them.

So things haven't stayed in line. And, you know, interest rates—if you borrow money, which you have to, you're just—you might say—"down the tube."

And another thing, of course, is the cheap food that we're expected to raise; 15 percent is about the price, I think right now, that the average person pays for his food out of his income. And of course that's the cheapest, about, in the world.

The other thing that goes along with this is our taxes and all the things that go along, that we have to sell on the world market. We have imports on strawberries out of Mexico; they come from Poland, they come from different places. Whether the wheat comes out of the Northwest or wherever— you know, we've got to get our own ship, our own farms, our own economy more in tune with the world because we have to sell on that market with anything that is raised on the farm. I say, I've been involved all my life in it; it seems like all the time—of course, I'm not on a crop that's, generally speaking, protected by the Government; everything should stand on its own feet, but it just seems like that these crops—we have to sell them, and we've got to do it at a price that we can make a profit at it. And our taxes on labor—of course, labor-wise, in our area we have used as high as 1,500 to 2,000 kids in the summertime for the strawberries and the zucchini squash and cucumbers and the crops that we used to raise. We don't have the Mexicans and the other—although we have more of them in here today—you know, in the past—I guess it's just that these other hand-harvested crops are about done for. Kids don't want to work anymore. We generally had 100 acres of strawberries; last year it was 50, this year we have 35. Next year it will be down to 20. Processing prices have gone real cheap. In 1982 we got $0.47; in 1983, we got $0.37 a pound; in 1984, it was down to $0.19 to $0.24, in that spread. It costs you $0.17 to pick them. This year they're back up a little bit, $0.28 to $0.30, somewhere in there, on strawberries. But you just can't do it on these kinds of things.

One thing that we would criticize from the Government standpoint and taxes, an outside business can put money off, profits, into the farm sector, whether it's—I'm not sure I should use the word, but Prudential owns a lot of land up in the basin; I have friends up there that are farming—they control—that kind of companies, or others, they can take money and they get a loss over here, they can write it off. And all it does is push the farm price down further. Seems like there's always some other farmer that will go out and take a contract that's cheap. Like right now, our sweet corn—we have 260-some acres of sweet corn that goes for processing. Two years ago they took $5 away from us; we're probably going to get it back.

Senator GORTON. You know, Mr. Erickson, the irony is that that advantage for those corporations and insurance companies was put into the law because many people thought it would drive up the value of farmland and thereby help the American farmer. They found it's turned around and bit them, of course, for just the reasons that you say. It actually lessens it; it makes competition very difficult.

The real irony is that some farmers supported that provision in the Tax Code in the first place, and now it's the devil to pay to get it out.

Mr. ERICKSON. Well, that may be true. You're more aware of how it started than I am, but I didn't really think the farmers started—where many people have money, they bought land, because land is always is a good deal——

Senator GORTON. Well, it's been very harmful to the farmer. Very.

Mr. ERICKSON. I've had more luck, I guess, in buying and selling real estate—sometimes to cover my own tracks— than I have in the crops because—if you walk through a store today, like our local ones, whether it's the Safeway or any of them, you go down and look at the price of strawberries and raspberries on the frozen containers, they are generally from five to six times what the market is that we get for it. And that's the same way with the sweet corn and the cob corn, way up there. After it leaves the farms, everybody gets a profit. That's great, but the farmer don't get it; it's just the co-op, and that's not the answer either. We're just beat down because they know that if we don't do it for them, whether it's a corn contract or whatever, there'll be somebody else out there to take it. I guess farmers are a poor bunch. I mean, as a business, we keep going.

I guess the other point I would make on taxes or unemployment—of course, we complain about these; we even have to pay unemployment taxes on kids, and that was one of our complaints, and we've been involved with the National Council of Agricultural Employers, whose main purpose is lobbying; and we've been to Washington, DC, to hearings; my wife's been back there. But just unfair taxes—there's no need for it. Our State industrial—it's clear out of hand, from $0.15 to, I don't know, $0.50 or $0.60 an hour that we have to pay right now—I don't have that exact—but you know where it's at. It's terrible. I don't know. You just can't pay all these kind of things.

The other part, the amount of hand labor that we have to use in any of these crops—and yet, you look at—I said we didn't have any Mexicans or that type of people around, but now we are getting more in the area, and I know that other areas have lots of them; and yet, if they're illegal we're going to be fined these huge amounts of—$1,000 a head, or person—if we don't have the people—the relief programs or whatever are too good. We don't get people out there to do some of these jobs that we have. It seems to me like we treat our neighbors, which is Mexico, very poorly. We bring over all the other people that we have—you know, the boat people and so on—and let them get on the dole, and yet the Mexican people come up and want to work and they're illegal or whatever, either we're going to be fined—and of course, for us to know if they are illegal is another thing, too.

I'm probably talking in circles, but a farmer is having a hard time today to try to make a profit.

Senator GORTON. OK, thank you.

Ms. Johnson.

STATEMENT OF DARLENE G. JOHNSON, PRESIDENT, WOODLAND TRUCK LINE, VANCOUVER, WA

Ms. JOHNSON. It just makes me think that farmers must be a lot like truckers: There's always someone out there that'll do it a little cheaper.

I'm Darlene Johnson, and I'm a practicing certified public accountant and I'm president of Woodland Truck Line. And I'm here today to express my views on the President's proposed tax reform and, specifically, how it affects the trucking industry.

First, I believe that a more stable tax law is imperative. Taxes are a fact of life, and businesses and individuals must know how they will be taxed if they are to plan effectively. A stable tax law that is less than perfect is infinitely better than a perfect tax law that changes every year. Arm and arm with a stable tax law is my belief that no tax law should be made retroactive.

The American Trucking Association has taken a position on the President's plan, and I attach a copy of their position to my remarks. Rate reduction, depreciation, investment tax credit, complexity and employee benefits are all addressed in their statement. And I agree with the association's position, with one exception. Therefore, I will only address that one exception and two other points that they didn't address at all that I feel are vitally important. The exception, which I am sure you already know, is the investment tax credit.

Small trucking and other small businesses desperately need the investment tax credit. It is the one area that we save the same dollar amount as our larger counterparts that we compete with. If a balanced budget or tax reform is contingent on eliminating the investment tax credit, then I suggest that the credit be limited to like a $25,000 annual credit that could be carried back 3 years and forward 5. I am not willing to trade the investment tax credit for a reduction in the top corporate tax rate. Woodland Truck Line has never seen the top corporate tax rate, and many other trucking companies haven't, either. In case after case, the investment tax credit is the deciding factor that makes the decision to purchase equipment cost effective for a small firm.

Point No. 2, as you well know, many small businesses —and I guess it isn't confined to trucking—have trouble financing expansion both in real estate, terminals, equipment and so forth. This is particularly true for trucking firms now. Last year, the trucking industry lost five firms every working day. The figures are increasing for 1985, and the comparable figure for 1978 was 162 firms for the entire year. Taxes, insurance, and other costs have increased from 200 percent to 1,000 percent; one tax was like 1,500 percent, but I figured you wouldn't believe that percentage so I didn't put it in. Many conventional sources of borrowing are drying up. My husband and I have owned and operated Woodland Truck Line since 1967, and 1983 was the first year that we leased trailers from an individual who purchased them specifically for us. The current tax law, although restrictive, does not eliminate that kind of financing. Without this source big firms, such as Consolidated Freightways, Yellow, Roadway, etc., that are capital-rich, will get richer while the small and regional firms will be squeezed out. I am opposed to any change in the real estate, interest, and leasing tax law that would reduce this source of funds for small business.

My third point—and it's an extremely important point, but it's not a part of the President's tax reform package, but I think it ought to be—and that is to correct a very unfair aspect of the heavy vehicle use tax that is currently being increased substantially. Canadian firms with whom we compete are exempt from this tax. The Transportation Act of 1980 eased Canadian entry into the United States and, with this easing of entry, many Canadian firms have developed extensive U.S. authority. They not only haul freight to and from Canada, but they haul freight that originates from and goes to points within the United States. The current situation penalizes American trucking companies operating in their own country. It constitutes a gross inequity. I brought with me the instructions on 2290 to show you the part where it says that if they are Canadian-based, they are exempt from this tax.

I would like to see, effective immediately, that Canadian trucks on our highways pay the same heavy vehicle use tax as the United States firms. Also, I would like to see the United States become more selective in granting authority to Canadian firms until the day comes that Canada makes it easier for United States firms to operate north of the international boundary.

In conclusion, tax reform should not be a disguised tax increase. I can't emphasize strongly enough that the trucking industry can't afford any more tax increases. The industry is going through tremendous changes, and when our effective tax rate for the industry is like 38 percent compared to the railroads 'whopping 2 percent, it's really tough to compete. If our tax burden is increased any more the industry may suffer a blow that will take years, and may never recover. And I don't believe that our Nation can prosper without a viable and efficient trucking industry to serve it.

[The prepared statement of Ms. Johnson follows:]

STATEMENT OF DARLENE G. JOHNSON

ON

TAX REFORM AND THE TRUCKING INDUSTRY

My name is Darlene G. Johnson, I am a practicing certified public accountant and president of Woodland Truck Line, of Woodland, Washington. My purpose in being here today is to express my views concerning the most recent Administration's tax reform proposal and how this proposal affects the trucking industry.

First, I believe that a more stable tax law is imperative. Taxes are a fact of life, and businesses and individuals must know how they will be taxed if they are to plan effectively. A stable tax law, even one that is less than perfect, is infinitely better than a perfect tax law that changes every year. Arm and arm with a stable tax law is my belief that any law changes should never be made retroactive.

The American Trucking Association has taken a position on the President's tax plan and a copy of their position is attached to my remarks. Rate reduction, depreciation, investment tax credit, complexity and employee benefits are all addressed in their statement. I agree the association's position with one exception. Therefore I will only address that exception and two other points that were not addressed which I feel are vitally important to the trucking industry. The exception is the treatment of the investment tax credit.

Small trucking and other small businesses desperately need the investment tax credit. It is one area in which we save as much as the larger operations with whom we compete. If a balanced budget is contingent on the elimination of the investment tax credit, then I suggest that the credit be limited to a $25,000 annual credit with a 3 year carry back and a 5 year carry forward. I am not willing to trade the investment credit for a reduction in the top corporate tax rate. In case after case the investment tax credit is the deciding factor that makes a decision to purchase equipment cost effective for a small firm.

Point number two, as you well know, many small businesses have trouble financing expansion both in real estate and in equipment. This is particularly true for a trucking firm. Last year the industry lost 5 firms every working day. The figures for 1985 indicate that this mortality rate is increasing. In 1978 the loss was 162 firms for the entire year. Taxes, insurance and many other costs have increased 200 to 1000 per cent. Many conventional sources of borrowing are drying up. My husband and I have owned and operated Woodland Truck Line since 1967, and 1983 was the first year in which we leased trailers from an individual who purchased them specifically for us. The current tax law, although restrictive, does not eliminate this kind of financing. Without this source the big firms such as Consolidated Freightways, Yellow, Roadway, etc. that are capital rich will get richer, while the small and regional carriers will be squeezed out. I am opposed to any change in the real estate, interest, and leasing tax law that would reduce this source of funds for small business.

My third point is extremely important to my business and to the trucking industry. I would like the tax reform package to correct a very unfair aspect of the Heavy Vehicle Use tax which is currently being increased substantially. Canadian firms with whom we compete are exempt from this tax. The Transportation Act of 1980 eased Canadian entry into the United States and with this easing of entry, many Canadian carriers have developed extensive U.S. authority. They not only haul freight to and from Canada, but also freight that originates from and goes to points within the U.S. The current situation penalizes American trucking companies operating in their own country. It constitutes a gross inequity. I would like to see, effective immediately, Canadian trucks on our highways pay the same Heavy Vehicle Tax as U.S. firms. Also, I would like to see the U.S become more selective in granting authority to Canadian firms until the day comes when Canada makes it easier for U.S. firms to operate north of the International Boundary.

In conclusion, I cannot emphasize strongly enough, that the trucking industry can not afford any more tax increases. The industry is going through tremendous changes and when our effective tax rate is about 38% compared to the Railroads whopping 2%, it is tough to compete. If our tax burden is increased any more the industry may suffer a blow that will take years from which to recover. Our nation can not prosper without a viable efficient trucking industry to serve it.

Before the

UNITED STATES HOUSE OF REPRESENTATIVES
HOUSE WAYS AND MEANS COMMITTEE

JUNE 27, 1985
WASHINGTON, DC

Statement of the

AMERICAN TRUCKING ASSOCIATIONS, INC.

On

TAX REFORM

Charles F. Zodrow
Chairman, Roadway Services, Inc.

BEFORE THE
HOUSE WAYS AND MEANS COMMMITTEE

Statement of the
AMERICAN TRUCKING ASSOCIATIONS, INC.

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on

TAX REFORM

Charles F. Zodrow

I am Charles F. Zodrow. I am chairman of Roadway Services, Inc., in Akron, Ohio. Today I am appearing on behalf of the American Trucking Associations, for which I am chairman of the Tax Policy Committee. ATA is a national federation comprising 51 state trucking associations, 11 conferences representing different segments of the industry, and over 3200 carriers.

SUMMARY

ATA supports immediate changes in the corporate tax system to more nearly balance corporate tax rates among industries. We believe the plan put forward last month by President Reagan will go far toward promoting corporate tax equity and fairness, and we urge Congress to adopt its major elements.

We make this recommendation even though many of the changes contained in the President's proposal could have an adverse impact on companies in the trucking industry. For example, the repeal of the investment tax credit would be particularly painful for an industry which must replace its fleet frequently. In fact, some companies in our industry might pay more if the tax credit is repealed, even with the rate cut, than under current law. The depreciation recapture proposal would also result in higher tax liabilities. Nevertheless, these changes would be worth the cost if Congress enacts a reduction in the top corporate rate to no more than 33%, as the President has proposed.

The corporate rate cut, along with preservation of lesser rates for small and low-profit firms and the enactment of a dividend deduction, is vital for reducing the unfairly high burden now borne by trucking and other high-tax industries.

The trucking industry is the highest-taxed industry in America. According to the study released last November by the Joint Committee on Taxation at the request of Representatives Pease and Dorgan, the average effective federal income tax rate for trucking in 1980-83 was 38.2%. This was more than double the all-industry average of about 18%, and 16 times the average of the lowest taxed industry, railroads, which had a 2.4% rate. In addition, trucking pays an enormous amount in highway and fuel taxes at both federal and state levels.

MAJOR PROVISIONS OF INTEREST TO TRUCKING

Rate reductions. The corporate rate cut, along with preservation of lesser rates for small and low-profit firms, is vital for reducing the unfairly high burden now borne by trucking and other high-tax industries. In fact, our support for tax reform rests on the enactment of a top rate no higher than 33%. We urge the Congress not to allow any compromise of this rate reduction for the purpose of funding special-interest provisions, whether corporate or individual.

Another important form of corporate rate reduction is the provision for deduction of 10% of dividends paid. Although this is a far cry from the 50% dividend deduction contained in the Treasury proposal last November, it is still worth retaining. Double taxation of corporate income is one of the most unfair distortions in our tax system. This provision is a good start on lessening that inequity.

Depreciation. The Administration proposes to create six asset classes in place of the present five, to apply a different pattern of deductions, and to index deductions for inflation. These changes, for both short- and long-lived property, provide more favorable treatment than under present law if inflation exceeds current rates, but not if inflation is negligible.

These changes are both appropriate and modestly beneficial to the trucking industry. The current depreciation system, of accelerated cost recovery with partial basis adjustment is actually less beneficial than pre-1981 law for assets that wear out fast, such as heavy trucks and tractors. In contrast, longer-lived property received an enormous benefit from the 1981 changes. We believe this proposal would produce more evenhanded treatment without destroying the incentive to invest in equipment and machinery.

Investment tax credit repeal. This is a costly provision for an industry like trucking that must replace its equipment every few years. Some trucking firms could actually have a higher tax bill under the combination of a 33% rate and no credit than they do now.

However, the industry and the economy as a whole will be better off under a system that levies approximately the same tax rate on all income. The investment tax credit has been one of the major reasons effective rates differ so much among companies and among industries. Provided the revenue from repeal of the credit is used to reduce the corporate rate to 33% or below, we are prepared to accept its repeal. We do urge the Congress to provide fair rules that would permit firms that ordered equipment but did not receive it by the time the repeal goes into effect to use the credit.

"Windfall" tax on past depreciation. This provision would require all taxpayers to add up their actual depreciation from 1980 through mid-1986, subtract the depreciation that would have been allowed under the straight-line method over the lives prescribed for calculating earnings and profits, and include a fraction of the difference in income. In 1986 and 1987, 12% would be included in income; in 1988, 16%. (If the difference was less than $300,000, or if total actual depreciation was less than $400,000, none of it would be subject to tax.)

We are troubled by both the principle and the cost of this provision. There is no windfall. These investments have already been made and depreciation has been taken in reliance on existing tax law, by firms acting in good faith and whose investment contributed to the economic recovery. Now they will bear the brunt of what is really a retroactive tax increase. We feel we must object in principle to this aspect of the President's proposal, which to say the least would set a bad precedent with unfortunate implications for future investment planning.

Some firms would pay more under this recapture than if the corporate rate reduction were delayed. However, we believe that on balance the industry and the economy will benefit more from immediate rate reductions with recapture than from delayed rate cuts without recapture.

Complexity. We often hear that complexity is not a problem for corporate taxpayers because they can just "put it in the computer." The truth is that changes in law are often very costly to comply with. To put it in the computer correctly frequently requires enormous effort to understand the law, its application to the firm's unique circumstances, and adapting it to the accounting system of the firm, computerized or not. Change and the uncertainty it brings can be expensive in upsetting corporate planning.

Therefore, we urge you to avoid making changes that add to complexity without adding significantly to either fairness or revenue. For instance, the Administration proposal refers to the November Treasury plan for depreciation as a basis for calculating earnings and profits and the minimum tax. Yet that plan was never put in legislative language, and it had a different number of asset types from either current law or the current proposal. Such a change seems unnecessary. So does the proposal for changing from a mid-year to a mid-month convention for depreciation. Although trucking is largely a domestic business, some members of the industry would be affected by changes in the foreign tax credit, which are also very complex.

Employee benefits issues. Several of the changes proposed in the taxation of compensation would affect many trucking firms. The most widespread is the proposal to include in income a portion of each month's health insurance premium ($10 for single coverage, $25 for family coverage). This would be an expensive accounting change and would do nothing to control health insurance costs. It is also unclear whether these amounts give rise to additional social security tax liability. If so, both administrative expense and tax cost would be increased, and we doubt this was intended.

Other changes that would entail new accounting expenses for many employers in the trucking business are the requirement that all employee awards be included in income, the denial of deductibility for half the cost of business meals costing more than $25 per person, and the integration of individual retirement account contributions with limits on section 401(k) plans. We urge you to consider carefully whether each of these provisions are necessary. If you conclude they are, we ask they be designed to minimize the administrative burden of compliance.

CONCLUSION

On balance, the Administration's tax package will be beneficial for the economy and for the trucking industry. The economy will gain from the greater work, saving, and investment called forth by lower personal and corporate rates; by the retention of investment incentives, such as accelerated depreciation, dividend deductibility, and a capital gains exclusion; and by the repeal or restriction of uneconomic special provisions that distort investment decisions.

We believe that for the industry as a whole, the pluses in the President's proposal outweigh the costly minuses. Corporate rate reductions will bring down our excessive effective tax rates. Depreciation reform and repeal of targeted special interest provisions will help to make the tax code more neutral with respect to economic decisions. Future economic expansion will be market-based rather than driven by tax policy.

We have encouraged tax reform along the lines of this proposal as a founder of the Tax Reform Action Coalition, and as a member of the Coalition to Reduce High Effective Tax Rates.

Therefore, ATA strongly supports the Administration's plan and urges you to approve a bill that incorporates its fundamental elements of capping the corporate rate at 33% or below, revising and indexing depreciation, and eliminating many special provisions. We recognize that some changes will be necessary for economic, technical, and perhaps political reasons. We stand ready to help members of both parties in that process, provided the basic principles above are maintained.

Senator GORTON. Thank you, Ms. Johnson.
Mr. Byrd.

STATEMENT OF WILLIAM F. BYRD III, PRESIDENT, PACIFIC DIE CASTING CORP., VANCOUVER, WA

Mr. BYRD. I'd like to express my appreciation to be able to express our views on this proposal. We are a small manufacturing outfit in Vancouver, and we are going to express our interest on 3 items of the 17 total that have been mentioned before.

First of all, corporate tax rates. Under the current system, Pacific Die Casting fell in the 15 percent tax bracket; I imagine all of the small businesses are at the low tax bracket. The President's proposal would keep us in the same tax bracket, and the Treasury proposal——

Senator GORTON. You mean the one from last November?

Mr. BYRD. Well, all right—there's the President's proposal and the Treasury proposal, and there are several others. But we're just addressing the President's and the Treasury's.

The Treasury proposal would have a 33 percent corporate tax for everyone, and that would increase our taxes by 120 percent.

The second item we'd like to discuss is investment tax credit. Die casting is a very capital-intensive industry. There are approximately 1,000 die casters in the country, ranging from small one-man shops up to big corporate divisions like Ford and General Motors. Pacific Die Casting has eight employees and three machines. Under the present law, we are allowed a 10-percent investment tax credit on equipment purchases. Both the Treasury's and the President's proposal would eliminate this investment tax credit. This would have a very devastating effect on our taxes. Under the President's proposal, our taxes would increase 74 percent; and under the Treasury's plan, our taxes would increase 220 percent.

Now, I've got some figures there for you that show exactly in dollars and cents. Last year, under the current rate of 15 percent, we had taxes of $3,546, all the way up to the Treasury plan that would cost us $11,292. In order to maintain the current percentage of profit under the new Treasury system, Pacific Die Casting would have to generate 25 percent more sales just to cover the new taxes.

The third thing is depreciation. The President has proposed a new system called the Capital Cost Recovery System and that would replace the Accelerated Cost Recovery System. I feel this new system complicates the concept of depreciation, and a new set of rules now will not provide any more accurate picture than is already being portrayed by the present rules.

I suggest keeping the current ACRS depreciation rules, possibly adjusting the rates to longer lives, if needed. This would provide the stability needed for compliance with the current rules and would not further complicate the depreciation systems being used.

In conclusion, between the proposed tax rate changes and deletion of the investment tax credit, our taxes would be doubled at the very least. Changes in the depreciation system would further complicate our recordkeeping. Our industry requires that we continue to upgrade our equipment in order to compete with the ever-increasing foreign market. We feel that these proposed changes will severely limit our capacity to survive in the future.

[The prepared statement of Mr. Byrd follows:]

Pacific Die Casting
Corporation

5712 N.W. Fruit Valley Rd. Vancouver, Washington 98660 (206) 695-6897

UNITED STATES SENATE
COMMITTEE ON SMALL BUSINESS

THE PRESIDENT'S TAX PROPOSALS FOR FAIRNESS, GROWTH, AND SIMPLICITY

TESTIMONY ON THE EFFECTS OF THE PROPOSALS ON SMALL BUSINESSES

given by

William F. Byrd III, President
Pacific Die Casting Corporation
5712 N. W. Fruit Valley Road
Vancouver, Washington 98660

August 16, 1985

I would like to express my appreciation for the opportunity to present our views of the Administration's proposed list of tax law changes. As a small manufacturing company, we are concerned that several of the proposals will have a very detrimental impact on our ability to maintain long-term viable income to meet future capital needs.

CORPORATE TAX RATES

Under the current system, Pacific Die Casting falls in the 15% tax bracket.

The President's proposal would keep us in the same tax bracket.

The Treasury's plan of 33% Corporate tax rate would increase our taxes radically by 120%.

INVESTMENT TAX CREDIT

Die casting is a very capital intensive industry. There are approximately 1,000 die casters in the country, ranging from small one-man shops to corporate divisions like Ford and General Motors.

Pacific Die Casting has 8 employees and 3 die casting machines. Under the present law, we are allowed a 10% investment tax credit on equipment purchases.

Both the Treasury and the President's proposal would eliminate the investment tax credit. This would have a very devastating effect on our taxes.

Under the President's proposal, our taxes would increase 74%.

Under the Treasury's plan, our taxes would increase a dramatic 220%.

Below is an example of the effects of the corporate tax rate change and the elimination of the investment tax credit on Pacific Die Casting, using our 1984 figures.

		% increase
Taxes under current rates-15%	$ 3,546.00	--
Taxes under Treasury rate-33%	7,802.00	120%
Taxes under Treasury rate plus elimination of investment tax credit	11,292.00	220%

In order to maintain the current percentage of profit under the Treasury's new system, Pacific Die Casting would have to generate 25% more sales, simply to cover the new taxes!

DEPRECIATION

The President has proposed installing a new depreciation system called the Capital Cost Recovery System (CCRS), which would replace the Accelerated Cost Recovery System (ACRS).

I feel that this new system complicates the concept of depreciation. A new set of rules now will not provide any more accurate picture of the correct amount of depreciation than the rules of the past.

I suggest keeping the current ACRS depreciation rules, but possibly adjusting the rates to longer lives, if needed. This would provide the stability needed for compliance with the current rules, and would not further complicate the depreciation systems being used.

CONCLUSION

Between the proposed tax rate changes and deletion of the investment tax credit, our taxes would be doubled at the very least. Changes in the depreciation system, would further complicate our record keeping.

Our industry requires that we continue to up-grade our equipment in order to compete with the ever-increasing foreign market. We feel that these proposed changes will severely limit our capacity to survive in the future.

Thank you for the opportunity to testify before the Committee on Small Business. If you have any questions, please feel free to contact us.

Respectfully submitted,

William F. Byrd III

William F. Byrd III
President
Pacific Die Casting Corporation

Robert M. Byrd

Robert M. Byrd
Vice President
Pacific Die Casting Corporation

Senator GORTON. Thank you, Mr. Byrd.

Just a few questions. Mr. Erickson, it seems to me that the main point of what you wanted to communicate with us is that we'd probably be a lot better off dealing with the deficit and fiscal challenges facing the country so that we got interest rates lowered than doing anything with respect to the Tax Code, from your perspective as a farmer?

Mr. ERICKSON. Well, I'd say that's partly right. Of course, investment credit and these other things that I kind of slipped around on are important, but right now, bottom line, investment isn't being made, although it has to be there. What these people say is definitely right. Investment credit—what Darlene said, too—if investment credit is there, that will change your mind where you will do it. Otherwise you'll go out and buy a used piece of equipment. For farmers, it's very difficult right now to even buy a new pickup. We have nine pickups at our place, on our farm, and the last new one I bought was a 1977. That's terrible. I bought four new pickups in 1974, still driving some of them. It's serious. And it's the same way with tractors; if a guy's in the market, he needs investment credit if he's to do it. But interest is No. 1; farmers use a lot of interest when they borrow money.

Senator GORTON. Both for Ms. Johnson and Mr. Byrd, I gather—I don't want to put words in your mouths—I take it that each of you does not believe that there should be any shift in the burden of taxation from individuals to corporations? You're not willing to pay more corporate taxes in order to get lower individual taxes, is that correct?

Ms. JOHNSON. Not entirely for me. I feel that there shouldn't be a shift from individuals to business, and that business can either be a partnership, a corporation, or an individual. Now, the President's proposal on this as it affects individuals in business is just as detrimental as it is as it affects corporations, and that's from businesses that I do as a CPA. My clientele—Woodland, WA, has 2,500 people—are small. I think I have about three corporations; the rest are individual businesses. I don't know of any of them that would want the investment credit gone.

Senator GORTON. Do you know any of them who would trade the present system for the new system? That is, say, lower individual rates in exchange for the investment tax credit on these others?

Ms. JOHNSON. Not my businesses, but my individuals, yes.

Senator GORTON. Mr. Byrd.

Mr. BYRD. Most of the corporations, even if they're not individually owned, are owned by people anyway. I mean, if they are going to tax us here and tax us there, it doesn't matter which way they do it; we're going to get taxed. My feeling is that a lot of these big businesses—the way the Government defines small business is 500 employees or less. That's kind of ridiculous.

Senator GORTON. There are a lot of pretty big small businesses.

Mr. BYRD. I mean, that's real big business, to me. Maybe they should have some more definitions in there. But a lot of the small businesses in the country don't get up to the 40-percent, 46-percent tax bracket, so that this 33-percent tax break isn't going to help us; it's going to increase the tax for us.

Ms. JOHNSON. You know, if you purchase a piece of equipment for $20,000 and you got a $2,000 credit because it's 5-year property, it takes a lot of taxable income to develop that amount of tax on an individual's return. I mean, you need a huge reduction to get a $2,000 reduction in tax; and a $20,000 investment for small business is not large. But I also agree that there may be a different breaking point, and that the tax law can be written so that some of the tax advantages are held for the really true small businesses.

In trucking, about 70 percent of the jobs are supported by the small trucking company. They don't haul that much of the freight, but they provide that much of the jobs.

Senator GORTON. And of course, by definition, trucking is a pretty capital intensive industry.

Ms. JOHNSON. Very capital intensive. Very, and getting more so.

Senator GORTON. So it's quite different from the service businesses that you represent as a CPA.

Ms. JOHNSON. That's true. But even like—I have some real estate dealers. They do buy equipment like a car, the change in the car rules has really affected them. None of them really like it, and I think they would rather go back to the old rules and not have the reduction in tax rates.

Senator GORTON. I also was quite intrigued by your testimony on the exemption of the Canadian trucking companies from that heavy equipment tax. That's fascinating, and I'll certainly keep that in mind. I think you have a very, very good point there.

Ms. JOHNSON. I know the Seattle carriers are very, very hot on that issue right now because it's unfair competition.

Senator GORTON. Mr. Erickson.

Mr. ERICKSON. I didn't realize they didn't have the same tax. We also have three diesel trucks that we use to haul our products with, and we do a little work against the competition with my neighbor here——

Ms. JOHNSON. We could haul his berries. [Laughter.]

Mr. ERICKSON. Not really. But I guess I complain a lot about—what the trucking industry is involved in so much is the different things between States that makes it so hard to keep up with. And our licensing, there's so much difference between Oregon and Washington. We do some prorating too; your overload permits are 80,000 up to 106,000 on a load. In Oregon, you pay virtually nothing, and here you pay $500 or $1,000 a rig to do that per year. I mean, the taxes are so much different; I'm appalled. And also, going through the port of entries it's almost like going into the stopper sometimes, the way you're treated. I don't know if you agree with that or not.

Senator GORTON. You're speaking Interstate, now?

Mr. ERICKSON. Interstate, yes.

Senator GORTON. Thank you all very much. Each of you has been a real help to us, as have been the other panels here today. We have a few more minutes if there is anyone here in the audience who has not had an opportunity to say anything and who is in or involved in small business. We'd be happy to hear from you for a couple of minutes. Anyone back there who would like to say anything?

[Inaudible voice from the audience.]

Senator GORTON. OK. That's fine, then we won't put that one on the record.

Is there anybody else?

[No response.]

Senator GORTON. If not, I want to thank not only this panel but the earlier panels for very enlightening testimony. We get a totally different insight into many of these questions when we come out to our own States and listen to the people whom they affect rather than just hearing from the professional lobbyists in Washington, DC. It's of great value to us. Thank you very much.

[Whereupon, at 11:15 a.m., the committee recessed, to reconvene at the call of the Chair.]

IMPACT OF TAX REFORM AND SIMPLIFICATION PROPOSALS ON SMALL BUSINESS

MONDAY, AUGUST 19, 1985

U.S. Senate,
Committee on Small Business,
Seattle, WA.

The committee met, pursuant to notice, at 1:30 p.m., in the fourth floor auditorium, Jackson Federal Building, Hon. Slade Gorton (acting chairman of the committee) presiding.

Present: Senator Gorton.

Staff present: Stewart J. Hudson, Lawrence G. Dalsin, Bruce Kendall, and Steve Oien.

STATEMENT OF HON. SLADE GORTON, A U.S. SENATOR FROM THE STATE OF WASHINGTON, AND ACTING CHAIRMAN, COMMITTEE ON SMALL BUSINESS

Senator Gorton. This is the second of two series of hearings of the Senate Small Business Committee which I will be chairing on the President's tax reform proposals. Many other hearings are being held around the country by other members of the committee.

This is the second set of hearings examining the effect on tax reform on small business from every perspective. The interest of this committee is in small business as the principal provider of jobs and of innovation in the economy of the United States.

Tax reform is, of course, not only a highly worthy goal, but one which should have a high priority in the Congress of the United States. The various tax reform proposals, the President's included, all attempt to create a tax system which is more fair than the present system. There is a great deal of lip service in addition to simplification of the tax system. Obviously, any tax system is going to include incentives for various kinds of activities, and the nature and the appropriateness of those incentives is a vitally appropriate part of any discussion of tax policy and of tax reform.

These goals play significant roles in the President's proposal, the earlier proposal released by then Secretary of the Treasury Don Regan in November 1984; and the two most famous congressional tax proposals, the Bradley-Gephardt proposal and the Kemp-Kasten proposal. Each of them, however, leaves all of us with various questions as to the degree to which they reach those goals and the degree to which those goals are sometimes inconsistent.

It is unlikely that the Senate of the United States will debate tax reform during the balance of this year. Under the Constitution, any such proposal must begin in the House of Representatives. The

House may very well pass such a proposal late this year which then is likely to be debated in the Senate of the United States early next year.

I don't believe that more than a handful of Members have made up their minds on precisely what they wish to have in any such proposal. In the case of this Senator, and I believe I speak for the other members of the Small Business Committee, we are very much interested in what small business has to say about the proposal, suggestions for changes, and suggestions for entirely new directions.

With that, as I have said, we have already had one-half day of hearings in Vancouver, WA on this subject, and we look forward to the different perspectives which we will hear here this afternoon.

We are delighted to recognize as the first panel two distinguished members of the faculty at the University of Washington. They are from the schools of business and economics. We will hear from each of you and then, I suspect, have some questions for you. We will simply go in the order in which you are listed on the program which is also alphabetical order and start with you, Professor Alkire.

STATEMENT OF DURWOOD L. ALKIRE, PROFESSOR OF ACCOUNTING, SCHOOL OF BUSINESS, UNIVERSITY OF WASHINGTON, SEATTLE, WA

Mr. ALKIRE. Thank you, Mr. Chairman.

My name is Durwood Alkire. I am a professor of accounting at the University of Washington teaching tax courses in the School and Graduate School of Business Administration. Before joining the faculty, I spent some years in public accounting and the Internal Revenue Service, so I have been interested in tax matters for many years. I spent a year on leave from the university as a Federal faculty fellow working for the Small Business Administration as senior advocate for tax policy for a year. Out of that experience, I acquired some interest in small business tax problems that I have retained.

Mr. Chairman, I believe on balance, the administration tax reform proposal is a good thing for small business and should be enacted. I think it is another step in the administration's general effort to get the country back to basics and away from gimmicks and put us all in the position of saying, like the TV commercial says now, we made money the old fashioned way; we earned it.

The basic benefit of the administration proposals to small business, like everyone else, of course, is the cut in rates. Any small business person, whether paying individual rates or corporate rates on business profits, will pay less taxes before credits under the administration proposals than under current law, assuming taxable income is the same amount.

Since the attempt of this proposal is to be "revenue neutral," obviously there are provisions increasing taxes in total amounts approximately equal to the revenue lost by the rate cuts. The question for small business in general is whether the benefits lost will be as great as the gains from rate cuts. I do not believe they will be for the average small business person.

The revenue estimates of the tax reform proposal prepare quite recently by the staff of the Joint Committee on Taxation show estimated revenue losses for the next 5 fiscal years, 1986 to 1990, of $305 billion for individual tax rate cuts and $137 billion for corporate rate cuts. So, we have $400 and some billion to make up.

Their estimates on the principal items producing additional revenue are, first, the repeal of individual deductions for State and local taxes at $166 billion; second, the repeal of the investment tax credit of $139 billion; third, the so-called recapture of rate differential on accelerated depreciation as some $57 billion.

The item having the greatest effect on small business, of course, is the repeal of the investment credit, but when you look at the history of this credit, it has largely been used by big business. The Treasury Department's statistics on income, taken from 1981 corporate returns, showed that of total investment credit of about $18.9 billion claimed by corporations, 82 percent of this or $15.6 billion was claimed by corporations with gross receipts over $50 million.

There are only 8,752 corporations in this bracket out of 2,812,430 corporations filing returns for that year. So, 0.3 percent of the corporations claimed 82 percent of the investment credit. If you take under $5 million gross receipts as a measure of small business, there are 2,709,000 corporations in that bracket, under $5 million. This is 96.3 percent of the corporations. They claimed 9 percent of the investment credit or about $1.7 billion.

Senator GORTON. Is it in proportion to the gross amount of business they conduct?

Mr. ALKIRE. I don't have those figures in mind, but it is even more heavily weighted to the big companies than their volume of business. The reason for that which I was just going to address is that, by and large, small business is not capital intensive. It is labor intensive. Its assets run more to accounts receivable, inventories, research and development than to plant and equipment, even pro rata to sales or gross receipts.

For this same reason, depreciation deductions are also heavily weighted toward large corporations that make the large investments. Therefore, the proposed changes in depreciation rates are not that significant to small business.

The rather technical provision to recapture the so-called rate differential on accelerated depreciation will have very little effect on small business, because you start out with a $400,000 exemption. Unless your depreciation in the base years of 1980 to 1985 was over $400,000, you don't even consider this. Then, if you are covered, the first $300,000 of so-called excess depreciation is exempted. So, the combination will obviously take out the great bulk of your taxpayers.

Now, to be revenue neutral, if you are going to have lower rates, you obviously must apply them to two different things. One, you have to apply them to more taxable income and, two, you have to reduce or eliminate some credits. There will be small business taxpayers who will pay more tax under the administration's proposal if they happen to have, for example, substantial depreciable assets in relation to the size of their business. There are obviously some small businesses that are capital intensive. and some of them will suffer under the new act.

I guess my only answer to that is I don't think you can write a law for 100 million individuals, 3 million corporations, and 2 million partnerships without hurting somebody.

There will also be individual small business persons who will pay more tax under the tax reform proposal because of nonbusiness provisions. The repeal of the individual deduction for State and local taxes will hurt some of them and also the provisions curtailing tax shelters. The combination of these things may more than offset the rate savings for some individuals.

I would say in answer to the complaints of those people that that is what we are trying to do and that increases in taxes for this kind of a person fit the general purpose of the reform proposal which is to come closer to taxing business and other income, curtail deductions for what are really personal items, and arrangements with little sound business or investment purpose such as some tax shelters.

There is really no tax reason for allowing one woman a deduction for the real estate taxes on her home and denying another woman who happens to rent and pays those same taxes indirectly by paying rent to her landlord. She gets no deduction. There are a lot of sociological and other reasons for this deduction that we have always had, but there really is no sound tax reason for doing this.

I would say in summary, Mr. Chairman, that obviously there are some objections from the small business viewpoint, and I am sure that is mostly what you hear is that people will be hurt by one provision or another and they come in and complain about it. But on balance, I think this is a favorable proposal to the majority of small business people.

I appreciate the opportunity to appear before you, Mr. Chairman, and if you have any questions, I would be glad to try to respond. If you want to have them later, we could do it then.

[The prepared statement of Mr. Alkire follows:]

STATEMENT OF DURWOOD L. ALKIRE, PROFESSOR OF ACCOUNTING, UNIVERSITY OF WASHINGTON, TO SEATTLE FIELD HEARING CONDUCTED BY U.S. SENATE SMALL BUSINESS COMMITTEE, SENATOR SLADE GORTON, CHAIRMAN

August 19, 1985

I am on the faculty at the University of Washington, teaching tax courses in the School and Graduate School of Business Administration. Before joining the faculty, I spent 30 years in public accounting and 10 years with the Internal Revenue Service, so I have been interested in tax matters for many years. During the year 1979-80, I was on leave from the University as an American Academy of Collegiate Schools of Business Federal Faculty Fellow, serving in Washington as a Senior Advocate for Tax Policy for the Small Business Administration, and I have retained an interest in the tax problems of small business.

Mr. Chairman, I believe that on balance, the Administration tax reform proposal is good for small business and should be enacted. I believe this is another step in the efforts of the Administration to get the country back to basics and away from gimmicks, to enable all of us to say like the TV commercial "We made money the old-fashioned way--we earned it."

The basic benefit of the Administration proposal to small business, as to all taxpayers, is the cut in tax rates. Any small business person, whether paying individual taxes or corporate taxes on business profits, will pay less taxes before credits under the Administration proposal than under current tax law, on the same amount of taxable income. Since the attempt is to make the Administration proposal "revenue neutral," there are provisions increasing taxes in total amounts approximately equal to the revenue lost by the rate cuts. The question for small business is whether in general the benefits lost will be as great as the gains from rate cuts--I do not believe they will be for the average small business person.

The revenue estimates of the tax reform proposal, prepared by the Staff of Joint Committee on Taxation, and released last month, show estimated revenue losses for the fiscal years 1986-1990 from rate cuts of $305.2 billion for individuals and $137.1 billion for corporations. The principal items producing additional revenue are as follows, with estimates for the same years:

	Billions of dollars
Repeal individual deductions for state and local taxes	166.3
Repeal investment tax credit	139.4
Recapture of rate differential on accelerated depreciation	57.4
Repeal second earner deduction	33.1
Adjust depreciation schedules	21.6
Tax employer provided health insurance	16.7
Repeal income averaging	16.7

The item having the greatest effect on small business is the repeal of the investment credit. This credit has, however, largely been claimed by big business. The Treasury Department's

Statistics of Income, based on 1981 corporation income tax returns, show that of total investment credit claimed of approximately $18.9 billion, the amount of about $17.2 billion, or 91 per cent, was claimed by corporations with gross receipts over $5 million a year, and $15.6 billion, or 82 per cent, by corporations with gross receipts over $50 million. There were only 8,752 corporations with gross receipts over $50 million, out of 2,812,430 corporations filing returns, so 0.3 per cent of the corporations claimed 82 per cent of the investment credit. If under $5 million gross receipts is taken as a measure of small business, the 2,709,009 corporations which might be termed small, or 96.3 per cent of the total corporations, claimed 9 per cent of the investment credit, or about $1.7 billion.

Depreciation deductions are also heavily weighted towards the large companies. The reason neither the investment credit nor depreciation deductions are as significant to small business in general is that small business is not capital intensive, it is labor intensive. Its capital is more heavily invested in inventories, receivables, and research and development, rather than plant and equipment.

The recapture of the rate differential on accelerated depreciation will have little effect on small business, because of exempting entirely taxpayers with less than $400,000 depreciation in the years 1980 to 1985, and then excluding the first $300,000 of 1980-85 "excess depreciation" from the recapture tax.

A tax proposal to reduce rates but be "revenue neutral," must apply the reduced rates to increased taxable income (and reduce or eliminate credits). There will be small business taxpayers who will pay more tax under the reform proposals, because they have substantial depreciable assets in relation to their taxable income, and the loss of the investment credit and the stretching out of depreciation deductions will be quite detrimental to them. My only answer to that situation is that with about 100 million individuals, 3 million corporations, and 2 million partnerships filing returns, it is impossible to write a tax law that will not be detrimental to some.

There will also be individual small business persons who will pay more tax under the reform proposal because of non-business provisions. The repeal of the individual deduction for state and local taxes and the various provisions for curtailing the use of tax shelters may more than offset the savings from rate reductions for some individuals. In my opinion, net increases in taxes for these individuals fit the general purpose of the reform proposal, to come closer to taxing business and other income, and curtail deductions for purely personal items and arrangements with little sound business or investment purpose, such as some tax shelters. There is really no tax reason for allowing one individual a deduction for the real estate taxes on her home, and denying another individual living in a similar home any deduction, because she pays taxes indirectly by paying rent to a landlord.

I know that most of the people you have heard from in Washington have had complaints about some specific provision of the reform proposal. I cannot let this opportunity pass without voicing my specific complaint on an issue detrimental to small business. This is the provision that taxpayers cannot use the cash method of accounting if they have gross receipts in excess of $5 million a year or use any other method of accounting in financial statements to owners or for credit purposes. In recent years, retailers, wholesalers, and manufacturers required to use the accrual method have been increasingly using the installment method to delay reporting their profit on sales until they collect cash. Contractors (including some manufacturers) have been doing even better by using the completed contract method to delay the reporting of the profit on a contract until years after the receipt of cash. It seems unfair to require service-type businesses to abandon their traditional cash method and report their income from customers, clients, or patients in advance of collecting it. The exemption of taxpayers with gross receipts under $5 million will of course cover many small business taxpayers. Some of this size, however, may lose the exemption because of being required by their banker or other credit grantor to furnish accrual basis financial statements.

Despite this minor complaint, I believe the Administration tax proposal is, on balance, favorable to small business. I appreciate the opportunity to appear before you, Mr. Chairman, and I would be glad to respond to any questions you may have.

Senator GORTON. Thank you, sir.
Professor Mariger.

STATEMENT OF RANDALL MARIGER, DEPARTMENT OF ECONOMICS, UNIVERSITY OF WASHINGTON, SEATTLE, WA

Mr. MARIGER. Thank you, Senator.

My name is Randall Mariger. I am currently an assistant professor of economics at the University of Washington. One of my primary interests is Federal taxation. I currently teach a graduate course on that subject each year.

I will begin by saying that I believe the latest Treasury proposal, the tax reform proposal, would, if it were enacted, be an improvement over the current tax law. In supporting this contention, I will not stray from the format of this session and will only address those aspects of the Treasury's plan that pertain to business taxation. Most of my comments will concern business interests generally and not specifically small business interests, although I will have at least one occasion to mention small business interests.

As Professor Alkire's testimony indicates, evaluating the current tax law as well as the Treasury's proposal requires that you simultaneously take account of the investment tax credit, depreciation allowances, and the corporate and personal statutory tax rates. Taking into account these components of the tax law correctly is a complex task. What it comes down to, however, is what an economist calls the effective rate of tax on capital income.

The effective rate of tax is quite simply explained. It is the proportionate difference between the before-tax rate of return on investment and the after-tax rate of return on investment. It is this tax rate, the effective tax rate, that affects the ability of business to invest profitably, and I might add that the effective tax rate has very little relationship to the statutory tax rate which, for corporations, now is 46 percent and, for individuals, ranges up to 50 percent.

I will begin by describing the current tax law as well as the Treasury's proposal in terms of effective rates of tax on various industries.

Currently the effective rate of tax on corporate source income, averaged across industries and taking into account personal taxes paid on dividends and capital gains, is 13 percent. But the current capital income tax is extremely nonneutral. What I mean by that is the effective rate of tax varies greatly across industries. Of 28 major industries, 3 currently have negative effective tax rates, 13 have effective tax rates between 0 and 10 percent, 8 have effective tax rates between 10 and 20 percent, and only 4 have effective tax rates in excess of 20 percent. Noncorporate businesses have lower effective tax rates than do corporate business, but the dispersion in the tax rates across noncorporate businesses categorized by industry is similar to that for corporate business.

The nonneutrality of the current tax on capital income is wasteful. It causes investment in projects that would not be cost effective if it were not for the tax advantages. That is, investment is drawn with the tax-preferred industries that have low social rates of return and away from heavily taxed industries that have high social rates of return. This inefficient allocation of investment inhibits the growth in labor productivity and real wages, so it ought to concern the average individual that we currently have a nonneutral tax on capital income.

The nonneutrality of the current capital income tax is largely due to the accelerated cost recovery system which was enacted in 1981 and the investment tax credit which we have had for some time. These provisions of the current tax law favor equipment, particulary short-lived equipment, over structures. The result is that equipment-intensive industries are favored by the current tax law, and this is largely responsible for the widely varying effective tax rates across industries.

The Treasury proposal, as you are aware, eliminates the investment tax credit, indexes depreciation allowances for inflation, aligns depreciation allowances more closely with true economic depreciation, and it lowers personal and corporate statutory tax rates. These modifications have two effects. They raise the effective rate of tax on capital income averaged over industries, and they tend to equalize the effective rates of tax across industries. The first Treasury proposal, for which I performed some calculations and which is less generous to business than is the current proposal, would have resulted in a 34 percent effective rate of tax on capital income for all industries. The effective rate of tax under the current proposal is less than 34 percent, and it is probably less than the 31 percent effective rate of tax that prevailed prior to the Economic Recovery Act of 1981.

To summarize, the current Treasury proposal is much more neutral than current tax law. The average effective rate of tax under the Treasury proposal is higher than the current average effective rate of tax but is probably lower than the average effective rate of tax that prevailed in 1980. This latter observation suggests that those who claim that the Treasury proposal, if enacted, would devastate a particular industry are greatly exaggerating their case.

Another favorable aspect of the Treasury proposal is that the lower statutory rate of tax on corporate income as well as the 10-percent dividend exclusion tends to equalize the rate of tax on corporate and noncorporate source income. This will result in a more efficient allocation of investment among corporate and noncorporate businesses.

Finally, let me say a few words about who gains and who loses under the Treasury proposal. Business interests tend to take the view that the Treasury plan affects them adversely if they pay more tax under the Treasury proposal than they do currently. This is not necessarily correct. A rise in the rate of tax for all industries, if we suppose that were to take place, would tend to be passed on to consumers in the form of higher prices. It would not affect one industry adversely relative to any other industry. What matters to a particular industry, therefore, is how much tax it pays relative to the tax paid by other industries. The service industries, for example, pay lower taxes relative to other industries under the Treasury proposal than they do currently. Service industries, therefore, would benefit from the Treasury plan despite the fact that they may pay more tax under the Treasury plan.

It is of interest, given this observation, that—as Professor Alkire observed—most small businesses tend to be concentrated in the service sector which is labor intensive. So, small business, to the extent to which they are in the service sector, will benefit by the Treasury proposal even though they may pay more taxes in an absolute sense. They will pay less tax in a relative sense.

As I already pointed out, all of us would benefit from the Treasury plan to the extent that we earn our income from labor. This is because a neutral tax ensures that investment is directed to its most highly valued uses thereby making workers more productive.

In conclusion, the Treasury proposal is sound and should be enacted. Some modifications would be desirable from an economist's point of view. Few of the changes currently being discussed in Congress, however, would be advisable.

Among the revisions I would advise against—I am not going to argue in favor of any revisions; I would be happy if it just went through as is—but I would argue against the following modifications. The first is the proposal to raise the statutory rate of corporate tax. It should remain at 33 percent if not lower. Second, we should not maintain the investment tax credit. There is some talk of reinstating that in the Treasury's proposal. Finally, we should retain the 10-percent dividend exclusion.

That completes my comments.

[The prepared statement of Mr. Mariger follows:]

Comments on the Treasury's Tax Reform Proposal

Presented at a hearing of the U.S. Senate Committee on Small Business
Senator Slade Gorton Presiding
Seattle, Washington
August 19, 1985

by

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Effective Tax Rates[1]

The taxation of capital income can be extremely complicated. It involves the investment tax credit, depreciation allowances, accrual accounting procedures, and statutory tax rates. What it all boils down to, however, is what an economist calls the effective rate of tax on capital income. This is simply the proportionate difference between the before-tax return on an investment and its after-tax return. For example, the effective rate of tax on an investment that yields a before-tax return of 10% and an after-tax return of 7% is 30%.

The effective rate of tax on corporate source income, averaged over industries and accounting for personal taxes, is currently 13%. Prior to the Economic Recovery Act of 1981, which allowed more generous depreciation allowances, this figure was 31%. Each of these numbers is computed assuming a 6% inflation rate.

The current distribution of the tax burden across industries is very unequal. Of 28 major industries, three have negative effective tax rates (construction, motor vehicles, and aerospace), thirteen have effective tax rates between 0% and 10%, eight have effective tax rates between 10% and 20%, and four have effective tax rates above 20%. This dispersion in effective tax rates is primarily due to the fact that the accelerated cost recovery system, as well as the investment tax credit, favor industries with large amounts of investment in equipment relative to that in structures.

These numbers were computed assuming the corporate form of business. Non-corporate businesses pay lower effective rates of tax but the dispersion in the tax rates across non-corporate businesses, categorized by industry, is similar to that for corporate business.

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[1] This section draws heavily from: Mariger, Randall, 'An Evaluation of the Treasury's Tax Reform Proposals, A report prepared for Senator Slade Gorton,' May 1985.

The current treasury proposal (Treasury II) eliminates the investment tax credit, indexes depreciation allowances for inflation, aligns depreciation allowances more closely with true economic depreciation, and lowers personal and corporate tax rates. For moderate rates of inflation, these revisions in the tax law have the effect of raising the effective rate of tax averaged over industries. It also substantially lowers the dispersion in the effective rates of tax across industries. I have not performed the exact computations for Treasury II. Computations I made for the first Treasury proposal, which called for depreciation allowances equal to economic depreciation and no preferential treatment of indexed capital gains, indicate that it would have resulted in a 34% effective rate of tax for all industries. (Again, personal taxes are accounted for.) Treasury II would result in an effective tax rate lower than 34% due to its allowance for some acceleration in the depreciation schedules and the continued preferential tax treatment of capital gains.

To summarize, Treasury II is much more neutral than the current tax law. The average effective rate of tax under Treasury II is higher than the current average effective tax rate but is probably lower than the 31% average effective tax rate that prevailed in 1980. This latter observation suggests that those who predict that Treasury II will devastate particular industries are greatly exaggerating their case.

The Desirability of Tax Neutrality

Why should the nonneutrality of the current tax on business income be of concern? The answer may at first seem obvious; it gives an unfair advantage to investors in tax-preferred industries. But this is not entirely true. To see this, consider the case of rental housing that, in 1981, was allowed substantially accelerated depreciation. The result was a building boom for rental units in certain areas of the country. Investors who were quick to take advantage of the tax change reap a windfall. Over time, however, the increased supply of rental housing lowers rents to the point where real estate investors are no better off than are investors in other industries.

A non-neutral tax system is harmful not because it is unfair but, instead, because it causes investment in projects that would not be cost effective if it were not for the tax advantages. That is, investment is drawn to tax-preferred industries with low social rates of return and away from the relatively heavily taxed industries with high social returns. This inefficient allocation of investment inhibits the growth in labor productivity and real wages.

Accessing the Impact of Treasury II on Particular Industries

Nearly all industries will pay higher taxes under Treasury II than they do currently. The most relevant question, however, is how heavily an industry is taxed relative to other industries. A rise in the rate of tax in all industries will tend to be passed onto consumers (laborers) in the form of higher output prices.[2] A rise in the tax of one industry relative to other industries, on the other hand, will cause the relative price of that industry's output to rise. This, in turn, causes consumers to purchase less of the heavily taxed industry's output.

It is important to note that Treasury II taxes service industries less heavily, relative to other industries, than does the current tax law. Small businesses benefit, therefore, to the extent that they are concentrated in the service sector.

Corporate Tax Integration

Corporate source income is currently taxed twice, once at the corporate level and once again when dividends and capital gains are taxed at the individual level. Corporate source income, therefore, is taxed more heavily than is other business income.

Economists are nearly unanimous in the belief that corporate income is ideally taxed only at the individual shareholder level. That is, the corporate tax should be integrated into the personal tax. The simplest method of achieving this would be to allow corporations to exclude 100% of dividend distributions (they are taxed at the shareholder level) and to levy a small tax on retained earnings (about 10%) to offset the advantages of deferring tax on retained earnings.[3] The Treasury proposal calls for a 10% dividend exclusion and a 33% tax rate. The Treasury proposal, therefore, is a small but important step toward full corporate tax integration.

Full corporate tax integration is at odds with the widespread belief among the general public that corporate taxes should be higher and personal taxes should be lower. I conjecture that this is due to the failure of the general public to understand that all taxes are ultimately paid by people. Once this is understood, it is apparent that a fair tax on corporate income requires that each shareholder be taxed in accord with their ability to pay. This can be achieved only if the corporate tax is integrated with the personal tax.

The only rationale for the preferential treatment of capital gains is that it partially alleviates the burden of taxing corporate income twice. Full corporate tax integration, therefore, should be accompanied by the elimination of the preferential treatment of capital gains.

Conclusion

Overall, the Treasury's's tax reform proposal would, if enacted, constitute an improvement over the current tax law. Relative to the current tax law, it is more neutral and corporate and non-corporate source income are treated more equally. Also, effective tax rates under the treasury proposal are not sensitive to inflation as are effective tax rates under the current tax law.

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[2] The higher business taxes allow reductions in personal tax that enable consumers to afford higher output prices.

[3] If retained earnings are not taxed, then shareholders are allowed to earn a return on money that should have been paid in tax.

Senator GORTON. That leads very easily to a first question. Conspicuously absent in that listing were the recapture provisions with respect to cost recovery. Do you think either from an economic efficiency point of view or from a point of view of abstract tax justice that those provisions are justified or should they be removed?

Mr. MARIGER. Well, to begin with, it would have no effect on the efficiency of resource allocation. The reason is that the amount that any firm would have to pay as a result of this depends on past decisions. It is like a lump-sum tax. Business cannot avoid it by investing less, for instance. So, it will not affect their investment behavior and, therefore, it cannot be inefficient.

The relevant question is, therefore: Is it fair to have this recapture provision? I believe it is because essentially what the recapture provision does is ensure those companies that took accelerated depreciation allowances in the last few years and who expected to have to pay the price later when they didn't get the depreciation allowances and therefore would suffer a 46-percent corporate tax rate, will inded pay that price. They expected that when they made those investments between 1981 and the current period. They expected they would have to pay future taxes at a 46-percent rate. If we allow them to only pay a 33-percent tax rate on those essentially delayed taxes that they didn't pay earlier, it would be a windfall to them. They would be paying less tax on income derived from past investments than they would if there were no tax reform at all.

So, the recapture provision is fair. It essentially treats those investments that took place between 1980 and currently exactly as people expected they would treated when they invested. So, I am in favor of retaining the recapture provision.

Senator GORTON. Professor Alkire, I think I heard Professor Mariger say as he went through his comments that this tax proposal is relatively neutral with respect to the incentives for a small business either to operate in a corporate form or not in a corporate form. I would like to know whether or not you agree with that proposition and maybe to amplify on that a little bit. As I listened to your testimony, almost all of it seemed to be directed at taxes on corporations. By the same token, most small businesses are not incorporated.

Do you think that this changes the bias or the incentives either to be incorporated or not incorporated and are the remarks that you made as applicable to an unincorporated business as to one which is in corporate form?

Mr. ALKIRE. The statistics, for example, Senator, I used were corporate because that is what is more readily available, but I don't believe the tax reform proposal changes the parameters for the decision either to be incorporated or not over current law materially, and I don't think it is detrimental one way or another. I would say my remarks would be equally true to either operating paying individual taxes or paying corporate taxes.

Senator GORTON. And you don't think that this tax reform proposal will change the rationale for either being incorporated or unincorporated to any significant degree?

Mr. ALKIRE. I don't think so. There will be borderline cases, of course, where the shift in the rates is such that it may now become desirable to be incorporated where it was not before at a particular income level. When you drastically change the individual marginal rate and also the top corporate marginal rate, that is going to happen, but I don't know any way you are going to avoid that. With millions of individual situations, you are going to have situations where any change in tax rates is going to change your decision as to incorporating or not.

Senator GORTON. A question that I would like each of you to comment on is, one can say—although I do so unapologetically—parochial in nature. Would you comment on the way in which this tax reform proposal treats the timber industry.

On Friday, we had two people speaking on behalf of various elements of that industry both of whom agreed that the tax reform proposal would, their words, be devastating to the appropriate management of woodlands to reforestation. Ironically, capital gains treatment was left only for those people who do not manage their lands and allow trees to grow without paying any attention to them. In fact, for small owners, requiring the capitalization of year to year expenses in managing timberlands not only would destroy their profitability of the value of the land but any incentive for appropriate timber management.

What are your general comments on those timber provisions; first, from the standpoint that they are a part of this package; and second, from the perspective of their impact on the economy of this State? I would like both of you to speak to it. If you are ready, go right ahead, Mr. Mariger.

Mr. MARIGER. Well, to begin with, there should never have been any special capital gains treatment given to timber. So, it was a mistake in my mind to have done that. It favored timber over other industries, and that is precisely what we want to avoid—as I already argued, we want a neutral tax. We want resources devoted to those industries which have the highest valued output, not those that have the greatest tax benefits.

The question then becomes what do you do once you have made the mistake and I think it was some time in the 1940's that this status was allowed for timber—that the gain on the sale of the trees would be treated as capital gains. I presume, and I am not certain of this, that the revocation of the capital gains treatment of timber is grandfathered in the current proposal. Trees that were planted previously are not affected by it. You can sell them and be taxed at capital gains rates. So it would not affect the profitability of past investments.

Senator GORTON. Excuse me, but that is only for harvesting in the next 10 years, so it is far shorter than a grandfather clause.

Mr. MARIGER. That is unfair. I think every tree that has been planted up until now should be granted capital gains status, but every tree that is planted from the day of the tax reform should not be given that status so people can make intelligent decisions on whether or not it is profitable to plant another tree on the basis of its true economic advantages or benefits as opposed to tax benefits.

Senator GORTON. You have already answered, it seems to me, from a theoretical point of view at least, and maybe a practical point of view, my question regarding capital gains treatment. But if you are not to allow capital gains treatment of the profits from the standing timber, isn't the rationale overwhelming that you should allow the year-by-year, full deduction of the expenses of managing a timber lot? Doesn't that increase the justification for that kind of treatment?

Mr. **MARIGER**. Well, that again is a tricky issue, and I don't want to go into it too deeply, but I would say that to tax timber as we do other assets, you would require timber companies to capitalize their expenses of planting and so forth. You have to match receipts with expenses to have neutral taxation.

The only argument for allowing people to deduct their expenses in the year of an expense is just that it is administratively too difficult to force them to capitalize, so you might want to exempt smaller operators from that sort of thing, but large timber companies, I believe, should be required to capitalize their expenses.

Senator **GORTON**. The third aspect of my question was what impact will it have on the economy here in this State?

Mr. **MARIGER**. Well, for one, as I said before, what can the timber company do about it? They can plant fewer trees. To the extent to which labor in timber companies in Washington is devoted to planting new trees, it would reduce employment of people in the timber industry in this State. I am not familiar with the figures on how many labor hours are devoted to harvesting and how many labor hours are devoted to planting. So, I am not sure.

It would, over time, shrink the industry. I am not sure how quickly it would shrink the industry. How quickly would depend upon how many people are involved in reforestation.

Senator **GORTON**. Professor Alkire.

Mr. **ALKIRE**. I would agree, basically, with Professor Mariger. As he indicated, the treatment of cutting timber as a capital gain started in the 1940's in World War II days, and the theoretical basis for this was that capital gains were intended to be gains in value of assets held over considerable periods of time and, therefore, trees qualified because companies or individuals held them for a long time before cutting. That kind of breaks down, like your theoretical argument for any capital gain, when you find that if you buy timber at least 6 months before the first of the year in which you cut it, you can have a long-term capital gain on cutting it.

The real reason for giving the timber industry capital gains in World War II days was because the Government wanted the timber cut and wanted lumber for obviously military purposes. When business faced up to 85.5 percent excess profits taxes in those days, they said, in effect, we are not going to cut these trees we have held for 30 years which are mainly profit and pay six-sevenths of it to the Government in taxes. So, if you want some trees cut and you want some lumber, we are going to have to have some kind of relief. At that point, they came up with capital gains on cutting trees.

So, I don't believe there has ever been any real good justification for that. It is like a lot of other things; once you have had it, it is tough to take it away.

As to the capitalization of, you might say, growing costs or development costs, this is very much in line with what we are doing in the tax law everywhere, of course, is getting away from letting businesses deduct expenses in advance of the related income and more matching and, therefore, more capitalization of expenses which are building up toward some later income.

Again, theoretically, I think this should be done. As a practical matter, timber has the benefit of deducting expenses currently so they don't like to lose it. I think you have to balance those two things.

Mr. **Mariger**. May I make one comment that I had neglected to mention?

Senator **Gorton**. Sure.

Mr. **Mariger**. Currently, the proposal allows capital gains to be indexed if it is to your advantage. If you are willing to have capital gains taxed as ordinary income, you can index them.

If you were not to allow these trees capital gains status but didn't allow indexation, that would be a real harsh blow to the timber industry. Over 30 or so years, inflation is going to be the major component of the appreciation in the value of the trees. This appreciation should be indexed if they are not given capital gains treatment.

Senator **Gorton**. One of the many changes between Treasury I and the President's proposal was to restore a number of the current special business tax preferences in favor of the oil industry. Is there any greater case which can be made for that restoration than there could be for the restoration of special treatment of the timber industry?

Mr. **Mariger**. No. It should be grandfathered just as the timber industry.

Mr. **Alkire**. I might add, Senator, that that is an admission against interest from Professor Mariger who came here not too long ago from Texas. [Laughter.]

Senator **Gorton**. We will consider him all the more an expert. Is your answer identical to his?

Mr. **Alkire**. Yes. To me, that is purely politics. It has no sound basis.

Senator **Gorton**. A more general question. Taking this tax reform proposal as a whole, does it reduce or enhance the incentives for capital formation and capital investment as against consumption? If it has any net effect in that direction, is it an appropriate net effect?

Mr. **Mariger**. Well, as I said to begin with, it is not an ideal tax law. It is better than the current tax law.

As I said before, the average effective rate of tax now is 13 percent. It will probably go up to something like 25 percent under this proposal. That combines personal and corporate tax. So, capital income is going to be more heavily taxed under this proposal than it is currently.

That will have an adverse effect on the total amount of capital formation. That is the negative side.

On the plus side, even though we will have a smaller amount of investment, at least it will be going to its most highly valued uses.

Senator **Gorton**. Is it your view that those two cancel one another out or will it have an adverse impact on the growth of the gross national product?

Mr. **Mariger**. I haven't cranked out any kind of model that would tell me that answer. My gut feeling is that we are better off with a neutral system. If Senators or Congressmen are concerned about the amount of capital formation, there is a third option, and that is essentially to have economic depreciation, no investment tax credit, and a lower corporate tax rate. That would be a neutral tax which would not raise the average rate of tax on capital income, and we can have the best of all worlds.

Senator **Gorton**. Quite bluntly, then, would you have engaged in all of the changes in the corporate tax that this proposal does?

Mr. **Mariger**. Would I——

Senator **Gorton**. Let me finish the question. Would you, since by and large you have approved of the changes which create a greater degree of neutrality, advocate not shifting the tax burden from individual income taxes to corporate income taxes, that is, would you support a considerably lower corporate tax rate and a correspondingly higher individual income tax rate?

Mr. **Mariger**. I am not sure I understand your question. The current proposal shifts the burden from the personal side to the corporate side.

Senator **Gorton**. Yes.

Mr. **Mariger**. Right. You are asking would I prefer the opposite?

Senator **Gorton**. Or at least no shift.

Mr. **Mariger**. Yes, I would have prefer a lower corporate tax burden. I have argued in my written testimony that there is very little justification for a separate corporate tax at all. It ought to be integrated into the personal tax. But again, I felt when I testified here that the best we are going to do, given the discussion I understand is going on in Washington, is this proposal. It is very unlikely we are going to have any changes in the proposal that an economist would advocate. So, I decided not to stray into that territory.

Senator **Gorton**. Professor Alkire.

Mr. **Alkire**. I don't really believe that the changes would affect seriously business capital despite the fact that Professor Mariger has indicated capital is going to be taxed more heavily. In the first place, I think we have over done how much incentive there is to a businessman to get the investment credit and to get high depreciation rates. I think they are kind of frosting on the cake. His basic decision is can I use this machine or whatever it is to make some money and am I going to be able to sell the product. That sort of question is much more important to him than whether he does or does not get a 10-percent credit and over what period he is going to recover the cost.

Unfortunately, I think the investment credit and rapid depreciation rates have been used much more vigorously along the gimmick line than they have along the business line. That is the area where they have really influenced the decisions by people going into ventures that they never would have gone into purely in order to get the tax benefits. Those are going to go which, in my opinion, is a good thing.

As one officer of a corporation that sells tax shelters was quoted in last Thursday's Wall Street Journal said, we are now going to have to redesign our product line to have economic driven ventures rather than tax driven ventures. That says it all to me. That is what it is all about.

I don't think that these added taxes on capital, if you want to call it that, are really going to be very serious for business.

Mr. **Mariger**. The econometric evidence goes either way. It is not clear how much people save as a result of the net rate of return. We have not been able to isolate how sensitive saving is to that, so that is why it is so difficult to say what a rise in the effective rate of tax on capital income will do to capital formation.

One thing we can say, however, is that a nonneutral tax is going to distort the choice of where the investment goes. So, I suppose that is why I come in on the side of neutrality, because we just don't have a precise number to indicate what would happen to saving as a result of taxing capital income more heavily.

Senator **Gorton**. I want to thank you both very much. You have been a great help. We appreciate your advice, and you can keep it coming. This will be going for some time.

Mr. **Mariger**. Thank you.

Mr. **Alkire**. Thank you.

Senator **Gorton**. Our second panel is on thrift institutions and credit unions featuring Mr. Beeksma, Mr. Soule, Mr. Schmidt, and Mr. Byrne. We will take you in that order and start with Mr. Beeksma.

STATEMENT OF B. R. BEEKSMA, PRESIDENT, INTERWEST SAVINGS BANK, OAK HARBOR, WA

Mr. **Beeksma**. Thank you, Senator.

I want to say that we appreciate the opportunity to address the issues you have raised today. I particularly think it is appropriate, since you have explored the timber industry in your recent discussion, and, of course, we in the thrift industry are financing housing which basically uses timber. So, we have a logical tie in there.

First, let me say that we, as an industry, applaud the move to simplify the Tax Code and to apply some kind of reform. The proposal, of course, is designed to be revenue neutral which we understand means in balance, and we understand in order to accomplish that, of course, some areas are going to be hit hard while others perhaps get some relief. That presumes also, then, that some areas have had previous tax benefits and they now will lose those benefits.

Unfortunately, we find that the thrift industry is going to be particularly hard hit with this reform. I want to object strongly today, not simply because we are concerned that it is our ox getting gored, but from the standpoint of equity and fact.

Our industry has had the highest effective tax rate of any of the financial groups, including commercial banks, credit unions, and life insurance companies. We have already had——

Senator **Gorton**. When you say your industry, are you speaking just of savings and loans or of savings banks as well?

Mr. **Beeksma**. I am talking about the thrift industry which would include both. Our effective tax rate has been the highest. Coupling that with the experience we have had the last couple of years relative to losses and problems in our industry, we feel it is highly inappropriate that we should be one of the groups that is hit the hardest in this tax bill.

We are also concerned, our league has taken the position that reducing the corporate tax rate to 33 percent will, in effect, be an acceptable increase for us. Our concern, of course, is that it is not going to end up at 33 percent. When it finally shakes out, it is going to be at some higher level, and that is going to compound the problem of increased taxes to us.

There are many different areas I could discuss, but I want to concentrate on two areas which are the most important to my way of thinking. The first is on the elimination of the bad debt deduction for tax purposes. The entire concept is simply being eliminated, and that, of course, has been in effect for many, many years.

Our business is unique in that over the last decades, we have concentrated on financing real estate. It is generally accepted that the cycles in real estate are long term and quite aggravated. They go up and down, and that has been the basis for the concept of establishing a reserve. There are times when the real estate market is hard hit that the losses are tremendous, and I cannot conceive of losses that occur once every 20 or 30 or 40 years in the real estate business being treated as current operating losses which they would then become under the tax reform proposal with the complete elimination of the reserve. That is one of our major concerns.

Of greater concern in the short run, of course, is that the consequence of that is the recapture of all of the previous bad debt reserves that our industry has accumulated and running those through the current tax situation. In the way of history, let me just remind you that it wasn't until 1951 that there was any tax applied to our industry at all, and then it was really of no consequence. In 1962, a meaningful tax law was approved which basically started us on a 40 percent of taxable income tax level at that time. It was subsequently increased one more time.

The point I want to make is that at each point in time that taxes were imposed on our industry, they were imposed prospectively with the idea that reserves that have been accumulated are there for a purpose and we won't bother those, and taxes were imposed prospectively. That level has been increased from 40 percent up to now roughly 68 percent of current income; 68 percent of current income is taxable, but again, it has always been prospective, and those reserves have been kept intact.

Now, we are talking, for the first time, about a retroactive tax. It is basically being applied not only on prospective income but retroactively on everything that has ever been accumulated in the way of tax losses by this industry. In essence, what it seems to me Congress is saying is that we don't think you need to be a thrift institution any more and, for that matter, you never have been one, because we are going to tax everything you have ever accumulated as a thrift institution in a tax-loss reserve.

An important element in that is the fact that in order to qualify for that bad debt deduction at the present time, we have to maintain 82 percent of our assets in housing-related assets. If we don't do that, we pay a normal tax rate like any other corporation.

That, of course, is going to go out the window with the tax reform. If we are simply told that we will be treated like any other financial institution, then there will no longer be any incentive to concentrate on housing. From our standpoint, that is doubly inequitable, because of the fact that all during these years, we were encouraged to make real estate loans through these Tax Code provisions, and now we will be left with some hundreds of billions of dollars of those real-estate loans on our books, many of which are at below market rates, and the Tax Code will be changed, and all the reserves that we were allowed to accumulate as an incentive to make those loans are going to be recaptured, and we will be left with the loans.

Perhaps a more equitable approach would be to have the Treasury simply buy those loans from us, and then we can be treated like anybody else. But I realize that is probably not very practical, but that is one of the concerns that we have at this point.

The concern I have is that I am talking about an industry that basically is facing a question of survival. You haven't had any difficulty finding in the newspapers in the last few years troubles that have hit our industry. I am talking about survival.

Our concern is that the recapture of that bad debt deduction is going to have an immediate impact on our bottom line that is going to make the headlines. Many people think that our industry needs more net worth, and the day that the bill is passed, the accounting profession will come to us and say now you have this large reserve account which is going to have to flow through taxable income. Therefore, you have a potential tax liability of *x* number of dollars on that and you will set that up immediately to account for that.

It is going to be measured in the billions of dollars, and there will be an immediate reduction to the net worth of the industry overnight even though the Treasury will not realize it until perhaps over a 10-year period or whatever the phase-in period is. It will be an overnight hit to the bottom line, and it will look like our industry has taken another severe hit, and that concerns me a great deal because we are dealing here with the faith and credit, I think, of our industry. That is one of my major concerns.

The second area that I want to address briefly is the provision to convert from cash to accrual accounting. Of course, the cash basis accounting treatment has had a long history and is something everybody has become accustomed to. It is very difficult to argue one against the other. What I want to concentrate on, however, is the fact that it will create a distortion.

At the present time, on the liability side of our business, we deduct the entire cost of interest paid on our savings accounts concurrent with our customers declaring it as interest income. On the asset side, we declare every dollar of interest we collect as interest income concurrent with our borrowers declaring it as an interest deduction.

This bill, as I read it, would require that we accrue all of that income and pay tax on it, but the borrowers are not going to be given the right to deduct that payment until they actually pay it. So, our borrowers will be on a cash basis. We will be on an accrual, and it will create some fictitious amount of income on which the Treasury can gain tax and, in fact, we may never collect that income because it is simply accrued income.

To me, there is a great inequity in that. It is trying to manufacture some income out of nothing that may never occur. I can see no basis in fact or logic for that line of reasoning.

Going back to the recapture provision, let me just argue briefly and give you a suggestion rather than just saying no. I think it is imperative that we maintain some kind of loss reserve situation in our industry in order to insulate us from the potential risks of real estate financing and also provide the added incentive to make real estate loans. I am suggesting one way to do that perhaps—we can debate on the amount we should have, but some reasonable amount.

Let's say that we would drop our deduction all the way down to 10 percent of our taxable income and that, along with a tax bracket of 33 to 35 percent, would leave us essentially where we are now, but it would preserve the reserves intact and it would prevent the recapture of those reserves. It would give us some ability to go ahead.

My real concern is the fact that we as an industry, in order to survive and maintain viability, have got to be able to attract capital and net worth in this industry. You know yourself the problems that we have had right here in the State of Washington in attracting capital and in providing an adequate return to those that have then bought that stock. There have been some people upset with the stock they have bought.

This, again, would be a disincentive and a disappointment to those people thinking of putting money into capital structure of thrift institutions. I think we need to encourage that.

The whole thing amounts to really, in my opinion, a double kick in the belly to an industry that is really flat on its back right now and needs some time to recover.

Senator GORTON. Thank you.

Ray.

STATEMENT OF RAY L. SOULE, PRESIDENT, GREAT NORTHWEST S&L ASSOCIATION, BREMERTON, WA

Mr. SOULE. Senator Gorton, Mr. Beeksma spoke basically to the industry and looking at the profound effect that the proposed tax act may have. I would like to take the information that he has supplied to you and say how this affects a living, viable corporation like Great Northwest Federal Savings, the company that I represent. So, I thought it might be interesting to look at Great Northwest, how we are today with no tax act, and how we might be given some of the ideas that Mr. Beeksma has suggested and certainly are implied in this act and show you in dollars and cents how it would affect us.

Let me mention just a little bit about Great Northwest. We are a mutual association. We are not owned by stockholders. We are owned by shareholders which means everybody that has a savings account and a loan with us has, in fact, a share of our equity as opposed to a private corporation like Mr. Beeksma might be.

The simple effect of increasing taxation, of course, is to lessen our equity position. That takes capital, like the prior speakers were talking about this afternoon. It takes some of that capital out of our system. We think that provides a very negative effect on the total picture of real estate as we are involved with it.

It is our intention in 1985 to pay about $1,171,000 in income tax. That is at an effective rate of 30 percent for the association and 46 percent on our service corporation which is taxed, obviously, at a different rate. Let me talk specifically, keeping in mind the $1,171,000--that is going to represent about a $4 million before tax income that we will generate and pay taxes at that base.

On a cash basis taxpayers, and that is something Mr. Beeksma talked about, the accrual would require us to convert to that system. Of course, that is very valuable to the industry, and I also believe that is valuable to commercial banks. However, to Great Northwest, it happens to be a moot question because we converted to the accrual system some time ago. So, that specifically as it would affect Great Northwest has no difference on our bottom line this year, but I think to the majority of institutions, it certainly would have a significant effect.

The investment tax credit was reduced earlier, somebody commented, to 5 percent for us. Even at a 5 percent in a growth mode which we are in right now in terms of new equipment and plant and that type of thing, it accumulates a substantial cash flow that benefits Great Northwest. So, it certainly is a benefit to us specifically, and it would be a problem if we were to lose the investment tax credit.

The percentage of bad debt reduction Mr. Beeksma talked about starting at 40 percent and going up to 60 percent in 1968. By eliminating that, it increases our effective tax rate to the neighborhood of 33 percent from about 28 to 30 percent. Then, it also would raise it in years to come from 32 to 34 percent. So, in terms of percent, there is about a 16 percent change as it would affect Great Northwest as we go along.

However, the most worrisome item is the potential recapture of the previously established tax basis reserve for loans. In the Great Northwest case, that portion of our net worth represents $13,575,000 at the end of 1984. If we are taxed at 33 percent, if that is the new tax rate, then that represents about $4.5 million, an enormous proportion for the size company that we are that we would have.

If we are required to write that off in 1 year, that is an enormous amount of reserves that we would have to establish for December 31, 1985 or whatever year was selected. If, on the other hand, it was done over 10 years, which certainly would appear to be the more reasonable approach of looking at this, then it would have some effects that I will also talk about.

Taking that information that I have just said, currently, if we look at it with $1 million pretax income and then multiply that out by whatever factors you would want to as it would appear to our corporations, if you had $1 million pretax income, we do have a bad debt deduction which represents about 34 percent right now to Great Northwest. That means that instead of $1 million, you would have $660,000 of taxable income. That is at a 46-percent rate, so that is $304,000.

Then, we also have some surtax exemptions and some investment tax credits and some things like that. What that would mean to Great Northwest is that we would pay $279,000 per million based on the tax laws the way they currently are.

Now, if we added the T-II plan where they would recover for loan losses in 10 years—and by the way that represents a 28-percent of effective tax rate—and we were to writeoff over 10 years that same income that we talked about, the $13,575,000, that would be $396,000 a year in extra taxes. That would that out of that $1 million, we would pay $720,000 in taxes which represents a 72-percent effective tax rate. For the next 10 years, it would be that kind of tax rate.

If, on the other hand, you look at it in terms of really what Great Northwest—it looks like a $4 million or maybe a little more, but to be conservative say a $4 million pretax year—and you effect all the things the President is talking about in that act, including the recapture at $396,000, we would pay in 1985 $1,710,000, and that represents a 43-percent effective tax rate.

So, just to look at us today, it looks like we are going to pay a 28-percent effective income tax rate. And if the proposals that are being proposed would go through, we would pay $1,710,000 and that represents 43-percent as an effective tax rate.

I believe that as we look at the whole picture of the real estate market, the thrift portion of it just represents a small one. We are not talking about the investors in or with Great Northwest, and I am not talking about all the different income projects and special projects that are out there that are being affected. I am just talking about one small segment, one small piece of the pie. That is the total real estate market.

Thank you.

[The prepared statement of Mr. Soule follows:]

FIELD HEARING (1)
U. S. SENATE SMALL BUSINESS COMMITTEE
August 19, 1985

Testimony By
Raymond L. Soule, President
Great Northwest Federal Savings and Loan Association

OBJECTIVES: Treasury II - Proposed Tax Reform Act

1. Discuss, in general terms, the proposed Tax Reform Act and its impact on the thrift industry and;
2. The possible affect of the Tax Act on Great Northwest as seen by our staff people.

The U. S. League (the major Trade Association of our thrift industry) has a specific program and I'll not repeat that program as they assured me that their information has been provided.

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(1) These are the notes of my prepared testimony. However, I only verbally discussed the portion dealing with Great Northwest as other speakers covered the points of concern dealing with the industry as a whole.

Major impacts of the proposed act: Industry Wide

The President proposed a tax that is fair yet provides growth and is simple. It also appears that "Revenue Neutrality" is the current vogue phrase in Washington D.C.

"Revenue Neutrality" was not applied to our industry as the "Treasury Drafters" of the White House act developed the proposal.

Many of the proposals would impact directly and adversely on our busines:

1. The Bad Debt Deduction Rule (IRC Section 593) would be repealed:
2. That portion of existing Bad Debt Reserves equivalent to what could be claimed using the bank Bad Debt Reduction Rule would be recaptured and phased into income over ten years for federal tax purposes.
3. Related to the first two proposals, all taxpayers would loose the reserve method of accounting for bad debts. Reserves would be recaptured and a system of direct charge-off would be imposed.
4. The special rules for carryback/carryover of Net Operating Losses would be replaced by the treatment offorded corporation, generally.
5. The accrual method of accounting would be required for all businesses with annual revenues of more than $5 million.

These are but five of the multitude of changes proposed in the President's tax proposals that would tend to have a profound affect on our industry.

GREAT NORTHWEST and the possible tax affect:

Now, to discuss Great Northwest. As you may or may not know, we are a mutual association - we are not owned by stockholders and our equity position is owned by the shareholders.

The simple affect of increasing taxation is to lessen our equity position or to limit our investment capital. You're aware of the spiraling down affect of removing investment capital.

It is our intention to pay in 1985m, between our Association and subsidiary corporation, $1,171,000 and this will represent an effective tax rate of 30% for the Association and 46% is the effective tax rate for our service corporation. A look at the major issues:

A. CASH BASIS TAXPAYERS:

Would convert to accrual basis - this is very valuable to the industry (including commercial banks). Great Northwest converts to accrual basis years ago and this item is a moot point for us.

B. INVESTMENT TAX CREDIT:

Reducted for S & L's earlier to 5% and then as a reduction of subsequent depreciation reduction. Even at 5%, in a growth mode, this accumulates substantial cash flow benefits to the Association.

C. PERCENTAGE BAD DEBT DEDUCTION:

Started at 60% of taxable income and effectively reducted tax rates to under 20%. Even at a lesser benefit that now exists, our tax rate is approximately 30%. This is lower than the proposed rate of 33% under T-II.

The percentage deduction is being phased out and within the next several years will be gone. Just this change could raise our effective rate from 28-30% to 32-34% or a 16% increase.

D. Perhaps the most worrisom item is the potential recapture of the previously established tax basis reserve for loan losses. This is that portion of Net Worth that has been untaxed as it was earned in prior years. For Great Northwest is was $13,575,000 at December 31, 1984.

If totally recaptured (taxed) over the next ten years, it could create a tax liability of enormous proportions ($4,500,000 +/- in total or 33% X $13,575,000).

Worst of all cases is that if recapture is required at 100% and an extraordinary adjustment at December 31, 1985 is required on the basis of previously untaxed amounts at future rates. There is some precedent for recapture under reules that normally only impact commercial banks, i.e. 1969 Tax Act.

PROPOSED TAX REFORM ACT
(As it would affect Great Northwest per million of earnings)
(000)

	Currently	T-II	T-II If reserve for loan losses is recovered in 10 years		T-II At increased income levels with recapture	
			100%	50%	100%	50%
Pre-Tax	$1,000	$1,000	$1,000	$1,000	$4,000	$4,000
Bad Debts @ 34% (% method over experience)	340	----	----	----	----	----
	660	1,000	1,000	1,000	4,000	4,000
Times (Tax Rate)	.46 304	.33 330	.33 330	.33 330	.33 1,320	.33 1,320
Tax Differential (A) on first $100 m/$75 m	(20)	(6)	(6)	(6)	(6)	(6)
Investment Tax Credit (Est.)	(5) (25)	(----) (6)	(----) (6)	(----) (6)	(----) (6)	(----) (6)
Tax	$ 279	$ 324	$ 324	$ 324	$1,314	$1,314
Recapture (B) $12,000,000 X 33% Rate over 10 years	----	----	(C) 396	(C) 198	(C) 396	(C) 198
Total Tax Paid	$ 279	$ 324	$ 720	$ 522	$1,710	$1,512
Effective Tax Rate	28%	32%	72%	52%	43%	38%

(A) This is known as the Surtax Exemption and the proposal would do away with the tier tax.
(B) Assumes $12 million of the $13,575 million is taxable.
(C) In these examples the applicable tax rate is increased significantly. As income increases the % would go down even though the dollars of tax on recapture would not change.

SUMMARY

First, we certainly support fairness, simplicity and growth as objectives of our tax system. While tax reform is of critical importance, it must not interfere with ongoing congressional deficit reduction efforts.

Second, we support the Administration's recommendations for a 33% maximum corporation rate. When operating profitably S & L's are typically taxed at a statutory marginal rate of 31.3%.

Third, we do not believe the Administration should eliminate the Bad Debt Reserve.

Fourth, we do not agree with the Administration's proposal to eliminate the separate treatment for financial institutions on treatment of the carryback/carryover of Net Operating Losses.

Sixth, thrift institutions should not subject to mandating accrual, rather than cash, accounting for tax purposes.

Other concerning areas move around, the deduction for state and local income taxes, the tax code provisions concerning reorganization of financially troubled thrifts and the redefining what a modern thrift is, for the purposes of financial institution laws.

I believe that we only represent a small segment of the total real property scene. The proposed tax program has a profound affect on the real estate market and also on those who invest in and with thrifts.

Thank you, Senator Gorton, for allowing me the opportunity to testify before this hearing.

Raymond L. Soule

Statement of

JOE C. MORRIS

President, Columbia Savings Association, F.A.

Emporia, Kansas

in behalf of the

U.S. LEAGUE OF SAVINGS INSTITUTIONS

before the

HOUSE WAYS AND MEANS COMMITTEE

Washington, D.C.

July 26, 1985

Summary of Major Points
Statement of U.S.League of Savings Institutions
House Ways and Means Committee
July 26, 1985

1. The U.S. League supports fairness, simplicity and growth as overall objectives of our tax system. The Administration's legislative request has stimulated a worthwhile review of provisions accumulated in the tax code over many years, including those affecting savings institutions.

2. While tax reform is of critical importance, it must not interfere with ongoing Congressional deficit-reduction efforts, or aggravate the threat the deficit poses to our national economic future.

3. The U.S. League supports the Administration's recommendation for a 33% maximum corporate tax rate. Savings institutions today, when operating profitably, are taxed at an statutory marginal rate of 31.3%. A 33% maximum corporate tax rate -- in conjunction with the recommendations which follow -- would allow savings institutions to profitably commit substantial resources to housing finance.

4. The Administration proposes elimination of the thrift institution bad debt reserve (Section 593) and recapture of a portion of prior allocations to that reserve. The U.S. League considers the recommended alternative, a specific charge-off of thrift bad debts, as inappropriate. We strongly oppose the specific charge-off method and, in particular, the unfair bad debt recapture which it necessitates. If Section 593 is eliminated, the U.S. League further recommends a go-forward fresh-start with a reserve method of tax accounting which more closely approximates actual loss experience.

5. Today most corporations are permitted an aggregate of 18 years for net operating loss (NOL) carryback/carryforward -- 3 back, 15 forward. Financial institutions are allowed a shorter combination of 15 years NOL carryback/carryforward (10 back, 5 forward). The Administration proposes elimination of the separate treatment for financial institutions. Furthermore, it would permit only prospective losses to utilize the revised NOL treatment. A 10-year carryback should be preserved for thrift institutions in recognition of the special safety and soundness concerns unique to depositories. To achieve parity with corporations generally, NOL carryforward should be extended from five to eight years. (Individual institutions should, however, be permitted to elect the 3-back, 15-forward general corporate NOL pattern.) The U.S. League strongly recommends that existing net operating losses remain eligible for any carryforward extension applicable to financial institutions.

6. Thrift institutions should not be subject to the Administration's recommendation mandating accrual, rather than cash, accounting for tax purposes. As financial intermediaries dealing with "retail" cash-basis individual taxpayers, our cash-basis institutions interact symmetrically with the cash-basis deductions and deposit-interest recognition on individual taxpayer returns.

7. The proposed repeal of the deduction for State and local income taxes creates a special problem for private-sector depository products in competition with U.S. Treasury issues (where interest remains exempt from State/local taxation) by denying a federal tax offset for State/local taxes paid by depositors on their interest income. The U.S. League would like to work with the Committee to minimize this distortion in offering yields and operating spreads, with its implications of increased costs for homebuyers and other borrowers.

8. The Administration's recommendation to continue until 1991 the tax code provisions regarding reorganizations of financially-troubled FSLIC-insured institutions and the treatment of FSLIC assistance is a welcome improvement to the immediate repeal advocated in the Treasury documents of last November. However, rather than automatically "sunset" these important protections to the FSLIC in five years, the U.S. League recommends that the Congress broaden their application to include FDIC-insured depositories and review whether to extend these provisions in 1991.

9. The Congressional Banking Committees are presently in the process of redefining what a modern thrift institution is for the purposes of the financial institution laws, including the use of a "qualified thrift lender" test. Ideally, a consistent qualifying assets test should apply for corporate tax as well as financial institution statutory purposes. The U.S. League, therefore, recommends deferring savings institution corporate tax revisions until Congress sets the framework for the future of specialized thrift institutions in the laws governing financial institutions.

Thank you, Mr. Chairman, and members of this distinguished committee. My name is Joe C. Morris and I am President and Chief Executive Officer of Columbia Savings Association, F.A., of Empor Kansas. I appreciate this opportunity to appear before you today my capacity as Chairman of the Committee on Corporate Taxation of U.S. League of Savings Institutions.*

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*The U.S. League of Savings Institutions serves the more than 3,500 member institutions which make up the $1.1 trillion savings association and savings bank businesses. League membership includes all types of institutions -- federal- and state-chartered, stock and mutual. The principal officers include: John B. Zellars, Chairman, Atlanta, Georgia; Gerald J. Levy, Vice Chairman, Milwaukee, Wisconsin; William B. O'Connell, President, Chicago, Illinois; Philip Gasteyer, Executive Vice President and Director of Washington Operations; and James O. Freeman, Senior Legislative Representative. League headquarters are at 111 East Wacker Drive, Chicago, Illinois 60601. The Washington office is located at 1709 New York Avenue, N.W., Washington, D.C. 20006. Telephone: (202)637-8900.

The U.S. League strongly supports the overall objectives of fairness, simplicity and growth advocated by President Reagan in his tax reform proposal. Few sectors of the economy have as much to gain from well-crafted reform efforts as savings institutions. As promoters of thrift and home ownership, we offer the straightforward type of loan and savings products which should be encouraged by the reform process. As a result, we are somewhat dismayed by adverse and unnecessary provisions in the Treasury package which would reduce our institutions' ability to serve our customers. We hope that, in working with your distinguished committee, we shall be able to revise these provisions into a more constructive form.

Certainly, every American shares the goals of encouraging capital formation, entrepreneurial activity, and job creation. Many of the provisions of the current tax system, though initially well intended, may no longer be serving those original purposes and should be reviewed. The Treasury study has been of real benefit in producing a comprehensive study of the special provisions incorporated over the years in the basic tax code.

Over 30 years worth of amendments have been added to the 1954 Internal Revenue Code. Each change has certainly produced new tax complexity without necessarily contributing to tax fairness.

Despite the good intentions of the framers of every special provision, there can be little doubt that the sheer complexity of the code and the growing public perception of its unfairness and arbitrariness have begun to threaten the essential broad-based support, voluntary compliance and self-assessment on which the system is based. Such a trend presents a real threat to the well being, fiscal integrity and even national security of our country. Such a threat clearly merits congressional response.

But another threat to those shared values looms even larger. That is the danger from uncontrolled federal budget deficits. Tax reform is an issue of critical importance, but it is vital that the reform effort should not interfere with deficit reduction efforts or, even worse, deepen the deficit .

The U.S. League has been strongly supportive of efforts to reduce the burden of projected deficits. We are alarmed by the independent projections of significant revenue shortfalls from the revised tax system advocated by Treasury. We recommend that the Congress examine proposals to reform the tax code from the constant perspective of tailoring that effort to mesh with the deficit reduction drive. The need for the incentive to economic growth from reductions in marginal income tax rates must be balanced with the retention of critical tax deductions embedded in both the tax code and the economic life of the nation. Casting the net so widely will require considerable Congressional review. We agree that the

Administration proposal is a logical starting point for tax reform, but we strongly suggest that insufficient attention has been paid therein to the sectoral impacts of the proposals, in addition to the above-mentioned uncertainties over the aggregate revenue impact.

As the major supplier of home mortgage credit to the nation, we are particularly concerned by the potential for severe impact on housing activity. The macroeconomic impact of the Administration's plan is also of vital concern to the thrift industry. It is by no means clear that the indirect benefits the package would bring in lower interest rates (from the projected increased savings flows at lower individual tax rates) will be enough to offset the direct burdens on homeownership costs. In addition, the adverse impacts of certain provisions of the reform proposals would severely limit the ability of our specialized institutions to continue to provide mortgage finance, and thus further increase the costs of homeownership.

Measuring the particular economic impact of the tax code changes is difficult even for individual items, but for such a broad range of simultaneous tax code revisions the difficulty is greatly compounded and resulting economic projections are less reliable. Our savings institutions have recently survived a prolonged period of high interest rates, deregulation of liabilities before assets, and increased competition for savings, which forced over 900 of our members to be merged, acquired, or liquidated.

Savings institutions cannot soon tolerate another bout of high interest rates. Our eroded net worth could not support the certain losses that would result.

We, therefore, urge the Congress to proceed with caution, examining where possible both the macroeconomic and sectoral impact of the President's plan in order to avoid potentially harmful and unforeseen damage to our underlying economic structure. As an integral part of the existing economic structure, savings institutions are deeply concerned about permanent economic distortions which might result from some of the proposed tax code revisions.

THRIFTS AS CORPORATE TAXPAYERS - A HISTORICAL PERSPECTIVE

The President's recommendations would totally restructure the tax treatment of savings institutions as corporate taxpayers. The core provision of savings institution taxation under present law is a special provision allowing a percentage of taxable income to be set aside as a bad debt reserve: almost all other unique aspects of savings institution tax flow from this one item. The repeal of this Section 593 special deduction would thus essentially eliminate the distinctive tax treatment accorded savings institutions by Congress for the last 23 years.

A brief look back into the history of financial institution taxation shows that as long ago as 1921 commercial banks were provided a reserve deduction for debts which become worthless during the year in addition to an allowance for future bad debt exposure. Savings institutions by contrast, remained exempt from federal taxation until 1951 when tax liability was imposed on income exceeding 12 percent of an institution's savings balances. Then in the Revenue Act of 1962, savings institutions, like commercial banks, became subject to regular federal corporate tax except for the option of the special thrift percentage-of-taxable-income bad debt deduction (Sec. 593(b)(2)). Congress, in granting this deduction, recognized the substantial risks involved with long-term lending and the importance of credit to finance homeownership.

This benefit was to encourage savings institutions to remain specialized housing originators and investors. Thrifts received the maximum tax benefits of Section 593 when 90% (pre-1969) of their assets were in certain housing credit-related and necessary liquidity "qualifying assets." Today (post-1969), 82% of savings and loan and stockholder-owned savings bank investments must be in cash, government and municipal obligations, real property loans, or other housing-related investments in order to receive maximum benefit from the bad debt percentage-of-income deduction. (Mutual savings banks receive maximum use of the percentage-of-taxable-income method when 72% of their investments are enumerated qualifying assets).) These housing-investment orientations are the "price" thrifts must continue to pay to enjoy the maximum tax benefits of Section 593. The special thrift bad debt deduction is denied to all thrifts, mutual and stock, savings and loan association or savings bank, if less than 60% are in qualifying assets.

As indicated, Congress in 1969 granted full use of the special thrift bad debt deduction to savings banks with a 72% qualifying assets ratio -- in recognition of historical differences between savings and loan associations and mutual savings banks. In the intervening years, the two types of institutions have become virtually indistinguishable, particularly with the passage of the Garn-St Germain Depository Institutions Act of 1982, which encouraged new investment flexibility to assure continued institutional viability. In the event that tax legislation in this Congress does not take the radical step of abolishing the special thrift tax treatment, we would recommend that all savings institutions be allowed full use of the bad debt deduction at the 72% level. The key role of thrifts in home finance can be expected to continue on the grounds of management expertise alone, absent any radical downgrading of homeownership benefits in the individual income tax structure. The asset composition test at 72% will assure the long-term commitment to home finance by all thrift institutions in the modern economic environment.

The record of savings institution commitment to housing is well established. Today the $1 trillion savings and loan business and the $300 million savings bank industry hold more than 50% of private residential mortgage debt and 40% of all mortgages nationwide. Thrifts have fulfilled congressional intent by serving as the primary source of credit for home buyers and sellers well beyond the expectations which prompted the changes made in the Revenue Act of 1962. Their housing specialization -- mandated, in part, through our federal tax code, has not, however, come without cost. Thrifts continue to face the peculiar risks of long-term home financing specialists -- incurring, in particular, significant operational losses from the inherited mismatch of short-term deposit costs and long-term investment returns during the recent high interest-rate period.

The Ways and Means Committee report accompanying the Revenue Act of 1962 clearly indicates that the special bad debt reserve approach was to provide "reserves consistent with the proper protection of the institution and its depositors in light of the peculiar risks of long-term lending on residential real estate." Congressman Keogh, a distinguished former member of your committee, also referred to the peculiar risks associated with long-term real estate lending in a March 28, 1962 floor speech advocating the new percentage-of-taxable-income reserve method. Keogh stated that a thrift institution:

> "----is a different kind of organization from a commercial bank----the matter of investment losses is quite different between the two types of organizations. Home mortgage investments are long-term investments with different risk characteristics than short-term commercial paper. It was clear to the Committee on Ways and Means that loss reserve provisions applicable to loss experience on commercial paper have no relevance to an appropriate reserve on long-term real estate loans.
>
> Actually there is no certain formula that will tell us what is the exactly appropriate loss reserve for long-term real estate loans. The very uncertainty of these losses is the problem."

Congress was extremely prescient in making provision for unforeseeable, extraordinary losses in the mandated home financing specialization. It is true that the losses ultimatel arose from the interest rate risk built into the mortgage portfolio rather than default risk, but the reserve accumulation permitted under the tax code was vital in weathering the storms of the last few years.

We emphasize that these tax favored reserves are not available for distribution to stockholders, but must be retained to cover the losses against which they were provided. Indeed, without the percentage reserve method granted our institutions in 1962, the thrift business might never have survived the devastating losses of 1981 and 1982.

The 1969 Tax Act was the last major revision of financial institution taxation. In the 1969 Act the allowable thrift percentage bad debt allocation was reduced over 10 years from 60% to 40% of taxable income. At the same time this phase-down of the bad debt reserve deduction was enacted, Congress attempted to reduce any negative impact of this change by granting financial institutions special net operating loss (NOL) treatment of 10 years carryback and 5 years carryforward in order to "provide an extra margin of safety to protect against the possibility of unusually large bad debt losses." (Report of the House Committee on Ways and Means to accompany H.R. 13270, the Tax Reform Act of 1969).

Since 1969 additional tax changes have been enacted which have altered the tax status of thrifts. The 1981 Economic Recovery and Tax Act provided greater net operating loss carryforward treatment (15 years) for ordinary corporations. Despite this significant enhancement of the regular corporate carryover period, financial institutions were held to their pre-1981 5-year carryforward level. The 1981 Act also required stock-form savings banks to maintain the higher savings and loan level of qualified investment (82%) in order to receive the maximum bad debt percentage deduction. In 1982 the Tax Equity and Fiscal Responsibility Act, and then in 1984 the Deficit Reduction Act combined to cut back by 20 percent the amount by which the bad debt reserve deduction (Sec. 593) exceeds the amount which would have been allowable on the basis of actual experience. This new corporate tax preference Section (Sec. 291) of the code -- which disallows a portion of preference items -- has somewhat undermined the traditional tax treatment originally accorded thrift institutions by Congress in 1962.

THRIFT TAX BURDEN INCREASES

The U.S. League believes that all corporations enjoying the fruits of our economic system have a continuing obligation to contribute adequate tax revenues to meet the expenditure needs of the nation. The thrift business is one industry which continues to meet its tax-paying responsibility in this regard.

In spite of the benefit of Section 593, thrifts have been paying an increasing amount of federal income tax beginning with the Revenue Act of 1962. This level was increased by the Tax Reform Act of 1969. The following Table I depicts the higher statutory thrift tax rate from the 1969 bad debt reduction, as well as the increased tax liability resulting from the bad debt cutbacks in the 1982 and 1984 Tax Acts.

Thrifts have essentially paid taxes at this statutory rate. Unlike money-center commercial banks which have used a variety of tax management techniques to reduce the U.S. tax liability on worldwide and U.S.-derived income to extremely low values, profitable thrifts face effective federal tax rates of approximately 30%. Table 2 depicts the actual federal taxes paid by thrifts over the 1970s. (The table stops at 1979 since beginning in 1980 many institutions sustained losses, and virtually the entire industry became unprofitable in 1981 and 1982; thus the percentage-of-taxable income method has been little utilized by thrifts in this decade.) In tax year 1985, however, the business will show the best earnings performance since the late 1970s and will return to significantly positive tax-paying status. Clearly, thrifts will continue to contribute their fair share of federal corporate revenues as they return to health.

TABLE I

Taxable Year Beginning	BDD-Percentage of Taxable Income Method	Statutory Tax Rate
1969	60%	19.2%
1970	57%	24.28%
1971	54%	25.27%
1972	51%	26.27%
1973	49%	26.93%
1974	47%	27.60%
1975	45%	28.26%
1976	43%	28.92%
1977	42%	29.26%
1978	41%	30.22%
1979	40%	29.46%
1980	40%	29.46%
1981	40%	29.46%
1982	40%	29.46%
1983	34%	30.36%
1984	34%	30.36%
1985	32%	31.28%

TABLE 2

Taxable Year	Pre-Tax Book Income	After-tax Book Income	Book Federal Tax Expense	Federal Taxes Paid
		($ millions)		
1970	$1,165	$925	$216	$186
1971	1,748	1,313	359	314
1972	2,317	1,687	517	457
1973	2,655	1,897	621	541
1974	2,143	1,482	532	468
1975	2,082	1,448	500	406
1976	3,218	2,249	775	628
1977	4,610	3,198	1,151	1,018
1978	5,716	3,916	1,435	1,275
1979	5,197	3,619	1,307	1,091

Source: U.S.League of Savings Institutions, Federal Home Loan Bank Board data cross-checked with Corporation Income Tax Returns (Treasury Department) for the various years.

Note that the combination of financial and tax return data produces a different value for the effective tax rate, the proportion of income taken by taxes, than the computation from the taxable income base. No single measure of tax burden is completely satisfactory. This method gives the lowest figure for the corporate tax bite.

RESERVE ACCOUNTING AND THRIFT PORTFOLIO RESTRICTIONS

The Administration's current proposal to eliminate Section 593 would reverse 23 years of tax and housing policy. At first glance, that may not be of too much concern. Today savings institutions, because of their portfolio specialization, do not utilize tax incentives enjoyed by other depository institutions and consequently the 33% rate proposed by the Administration closely approximates current thrift marginal tax rates.

The Treasury tax reform plan, however, goes much further than abolishing the special thrift bad debt reserve method. The plan would abolish entirely the reserve method of providing for bad debts by all taxpayers. Instead, a system of specific charge-off would replace the traditional and well-understood reserve methodologies. (Today most corporations may utilize a six-year moving average of bad debt experience, a method also available to thrifts and commercial banks; commercial banks have a second option of the use of a percentage-of-eligible-loans bad debt addition; thrifts may use either the moving average experience, commercial bank eligible-loan or thrift percentage-of-income methods).

The Treasury argues that any reserve method of accounting for bad debts overstates the true size of bad debt losses and that the charge-off system, delaying any deduction for such bad debts until actual write-off, is preferable theoretically and more accurate practically. We do not accept such a contention. Though there may be some legitimate debate, over "excessive" deductions from certain hitherto permissible bad debt methodologies, such debate is a separate issue from the question of the validity of reserve accounting. In fact, such reserve accounting is clearly required on theoretical grounds in the accrual basis of accounting which the Treasury advocates elsewhere in its reform package and which we shall address later in this statement.

The U.S. League strongly urges the retention of some method of reserve accounting for bad debts for all corporate taxpayers generally and a separate review of financial intermediary bad debts' reserves in particular. For most corporations not engaged in the business of lending funds, except perhaps in the form of trade credit, bad debt losses are probably a minor and incidental expense. Even so, equity demands a more generous system than specific charge-off. For financial intermediaries, bad debt reserves are an integral part of their basic business and deserve more analysis than offered in the Treasury package.

Specific charge-off as a substitute for reserve accounting is totally unsatisfactory. The method fails to take into account the timing of the lender's economic loss from bad debts. These economic losses occur much earlier than the point at which a loan can be formally written off for tax purposes. The write-off for a bad loan is usually the last step in a drawn-out process which starts when a loan becomes troubled, continues through a work-out or foreclosure period, and culminates only when a loan is either finally collected or written off.

Specific charge-off postpones the tax recognition of any loan loss expense until after this expense has been incurred economically, whereas reserve accounting more accurately measures economic income.

PROPOSED RECAPTURE OF BAD DEBT DEDUCTIONS

In addition to the theoretical shortcomings of the proposal to eliminate the reserve method of accounting for bad debts, this flawed element of the Administration package brings with it a host of ancillary complications. The proposal is intimately linked to the requirement to "recapture" the tax benefits from past bad debt deductions.

Henceforth, when assets go bad, the loss will be charged directly to taxable income rather than to a tax reserve dating back to the original investment period. (If accumulated bad debt reserves are not recaptured, taxpayers would, in effect, get a double deduction -- once, at the time of the initial addition to the reserve, and, second, in the future when the loss is directly charged on the tax return rather than to the reserve.) Consequently, under the Administration's plan, all accumulated bad debt reserves are recaptured so that every taxpayer's returns will retroactively be revised "as if" this new system had always been in effect.

Retroactive legislation is seldom advisable. When a "go forward" proposal mandates such a complex retroactive adjustment, warning signals are being sent. This entire section of the package requires rethinking.

For savings institutions, the impact of the recapture proposal is peculiarly adverse. The burden of actually having to pay the tax may be the lesser of the associated problems for savings institutions. The special bad debt reserves accorded thrifts since 1962 were in return for their concentration on residential finance. That concentration, in an era of deposit rate deregulation, combined with historically high interest rates, proved exceptionally costly to many institutions. The Administration partially recognizes that connection and has not proposed a recapture of all the benefits of the special thrift bad debt deduction but only that part equivalent to what could have been claimed had the thrift bad debt method never been enacted.

The portion to be recaptured would be the greater of the commercial bank method (Section 585) and the actual loss experience. (Treasury officials have yet to declare the precise calculation of the equivalent "commercial bank reserve" to be recaptured.) Furthermore, under the Treasury's plan, this amount could be taken into income by the thrift either in the first year or over 10 years. Though this partial recapture approach appears to be "fair", it hardly leaves an institution in the flexible investment portfolio position of a commercial bank. Not only would the President's plan eliminate all special tax incentives for thrifts to continue to focus their investment in housing, it would also retroactively penalize institutions by bad debt recapture.

We estimate that the associated tax liability over ten years would be approximately $2 billion for our institutions. However, the financial statement impact would not be deferred over that period.

In its consideration of how to reflect the tax savings for an institution from the use of the thrift bad debt reserve method, the accounting profession accorded that benefit the status of a permanent difference between book and tax return income. The provision enacted in 1962 and adjusted in 1969 was not scheduled for phase-out, as was the case for the commercial bank method and no mention of recapture was ever made.

Consequently, the thrift tax savings flowed through the income statement into the net worth accounts of the business, quite unlike the situation at commercial banks, where the tax savings was transferred to a deferred tax liability account. Commercial banks will face the cash flow burden of actually paying the recapture tax. Savings institutions will first have to reflect a new tax liability on their books far in advance of the actual payment of the tax.

At the moment and by coincidence, the entire financial accounting methodology of reflecting the impact of changing tax laws and rates on the financial statements is in flux. Because of the uncertainties in the relative timing of the tax law and accounting principles revisions, no definitive answer on the magnitude of financial statement impact can be given. However, it appears in all likelihood that savings institutions will encounter a uniquely severe impact from the recapture of bad debt reserves as recommended by the Administration.

The Financial Accounting Standards Board (FASB) is expected to require immediate creation of a deferred tax liability on thrift financial statements. So while the tax impact can be spread over 10 years, the financial statement impact from recapture could be immediate, wiping out at one stroke a substantial portion of existing thrift institution net worth nationwide.

Following the massive erosion of net worth in our industry 1981 and 1982 and the slow return to profitability thereafter, this check to thrift sector recapitalization by reserve recapture will be sorely felt by both the housing sector and the federal agencies responsible for insuring depositors against institutional failure.

Even the need for revenue neutrality with the President's Tax Proposal does not justify such an inequitable result. In any event the adverse impact on fragile thrift financial statements far outweighs the minimal revenue pick-up.

PRESERVING SOME RESERVE FOR THRIFT INSTITUTIONS

The entire question of reserve method accounting for thrifts should be carefully studied by Congress. The existing system was enacted in recognition for the portfolio restrictions characteristic of both federal and state-chartered thrift institutions in 1969. Clearly, some significant (though modest) liberalization of asset authorities has been achieved at both federal and state levels in the intervening quarter-century -- but that liberalization has been accompanied, indeed preceded, by total deregulation of savings deposit interest rates. So far, the outcome of the deregulation process has been to weaken, rather than strengthen, institutions -- though, at this point, the future looks far more promising.

Even so, it would be appropriate for this Congress to take cognizance, as did its predecessor, the 87th Congress, of the continuing portfolio restrictions on savings institutions. While the Administration's tax proposals implicitly assume that absolutely complete investment freedom has already been granted to thrift institutions or will be shortly, the Banking Committees in each House of Congress have legislation under review which would maintain a number of significant constraints on investments by federally-chartered thrifts and, for the first time, impose federal limits on the exercise of state-charter empowerments. (On June 12, the House Committee on Banking, Finance and Urban Affairs reported H.R. 20 which substantially revises the "qualifying assets" test and applies it to new purposes; similarly, the Senate Banking Committee has under active review companion legislation.)

Though the outcome of that legislative process cannot be predicted with certainty and since some restriction on unfettered use of state powers is warranted to protect the Federal Savings and Loan Insurance Corporation, it would be appropriate for this committee to reconsider whether or not to retain some special tax incentive for home finance specialization.

Given these concurrent developments in the Congressional committees responsible for the framework of modern thrift institution activities, the U.S. League strongly recommends that your distinguished Committee consider the deferral of tax reserve and recapture for thrift institutions until the Congress has acted on the pending Banking Committee legislation.

If delay is not possible, as outlined above in the table of statutory rates, the 33% regular corporate rate proposed by the Administration comes relatively close to the current 31.3% rate applicable to thrifts making full use of Section 593. This close correspondence makes it possible for our institutions to contemplate the loss of the special bad debt deduction, but the need to retain some tax incentive to compensate for the opportunity cost of continuing portfolio restrictions still remains.

In addition, the problems from the elimination of the reserve method of accounting and from bad debt recapture cry out for solution. One approach which could address all of these problems simultaneously would be to revise the special thrift bad debt deduction from its current effective level of

32% (the statutory 40% level reduced by the 20% preference scaleback under the 1982 and 1984 tax acts) down to 5%. This 5% level would reduce the statutory thrift rate to almost exactly the 31.3% present level, assuming a new general corporate rate of 33%.

Such a reserve method retention would eliminate the need for retroactive recapture linked to specific charge-off, would narrow the gap between experience-level losses and thrift bad debt deductions, and would provide a mechanism whereby the fragile thrift sector could be insulated from any subsequent movement from the suggested regular corporate tax rate level of 33%.

Any increase in the recommended, basic 33% corporate rate without special provision for our institutions -- for example by the retention of a special bad debt deduction -- will seriously jeopardize our business and its ability to fulfill its role as the nation's primary source of home mortgage credit.

For this and the previously mentioned reasons, the U.S. League opposes the imposition of the charge-off method and recommends forgiving accumulated build-up of past bad debt reserves and making a fresh start with a reserve method which more closely approximates actual loss experience. A number of technical issues arise in this area relating to the restrictions on any grandfathered reserves (and thus will arise even under the Treasury plan). These questions revolve around Section 593(e) and we would be happy to discuss them with Committee staff. Despite these technical complexities our overall position is very simple: If recapture is not eliminated, the U.S. League cannot support the President's tax reform proposal.

PRESERVING EXISTING NET OPERATING LOSSES

Financial institutions have operated since 1969 using a net operating loss treatment of 10 years carryback and 5 years carryforward. At the time, this was a more generous departure from the general corporate rule of 3 years carryback and 5 years carryforward.

Subsequent changes in tax law and regulation have reversed that favored position for savings institutions. In 1979, the Treasury, without any legislative prompting, adopted a new regulation whereby the tax refund benefit of an NOL carryback was halved. Under that regulation, institutions were required to reduce the allowable special thrift bad debt deduction by an amount proportional to the amount of the NOL carried back to that previous positive tax payment year. The effect is to increase the tax liability of the institution and reduce the refund. This change was made, by coincidence, exactly at the time when widespread operating losses begin to threaten the business. Its impact on tax recoveries has been severe. Citing the need to "provide an extra margin of safety to protect against the possibility of unusually large bad debt losses," Congress had provided the benefit of a longer carryback for net operating losses to offset reductions to the thrift bad debt reserve contained in the same 1969 Tax Act.

Shortly after this IRS regulation, in 1981 the Economic Recovery and Tax Act (ERTA) left the NOL rules for financial institutions unchanged at a time when nonfinancial corporations were granted a more favorable 15-year carryforward authority. This new rule, plus the existing 3-year carryback, provided nonfinancial corporations with a greater 18-year net operating loss aggregate carryover period than the combined 15-year treatment (10 back, 5 forward) afforded financial institutions. Moreover, ERTA also allowed nonfinancial corporations to use the extended period against losses incurred in 1976 and subsequent years, not just those incurred after 1981.

The loss of the superior combined carryover period has occurred at a time when such benefits would be most beneficial. The losses incurred by savings institutions from historically high interest rates clearly fall into the category of unique risks contemplated by Congress at the time special rules were originally granted. Special provisions for these entities are clearly warranted.

The Administration's 1985 tax reform recommendations propose applying prospectively the general corporate carryforward rules to thrifts. This denial of extended NOL carryover treatment for existing losses runs counter to the clear precedent established in 1981 under ERTA, as well as violating the congressional intent of the 1969 Tax Reform Act granting financial institutions a superior NOL treatment in recognition of the special safety and soundness concerns which are unique to depositories.

The general rationale for net operating loss carryback and carryforward is that a taxpayer should be able to average income and losses from a trade or business over a period of years to reduce disparities from fluctuating incomes. This rationale is particularly appropriate for thrifts whose long-term investment portfolios make their income particularly vulnerable to sudden increases in interest rates.

Full carryforward opportunity for net operating losses is especially important for institutions which have assisted the federal insurance agencies (FSLIC and FDIC) by participating in supervisory mergers -- acquiring troubled institutions operating at substantial losses. Denial of equitable tax loss carryforward opportunities will further complicate the task of the FSLIC and FDIC in attracting future merger partners.

In addition, the important role of financial institutions within the business community requires that they be given at least net operating loss parity with other corporations, both in terms of aggregate years, as well as in the ability to utilize existing losses fully.

The U.S. League, therefore, recommends granting overall carryover period parity to thrifts by retaining our longer NOL carryback treatment and merely extending our NOL carryforward to a total of 8 years. The U.S. League strongly urges, as a matter of equity and to reflect the nature of the losses in the 1980 to 1982 period, that the existing net operating loss overhang be included in these revised NOL rules. A number of institutions facing the most severe NOL carryforward problem may even be attracted to the longer carryforward period of regular corporations, again provided that the longer period be made available for existing NOLs. In such cases, it would be appropriate to permit a one time, irrevocable option for institutions to elect regular corporate rules as regards NOL carryovers for all outstanding and future losses. This provision, with appropriate transition rules, would be of real value to a number of institutions and is fully consistent with the general concept of NOL offset.

CASH TO ACCRUAL ACCOUNTING

The Administration's tax proposals would limit the use of the cash accounting method employed by virtually all savings institutions as well as a wide array of other service industries. Under this proposal, the cash accounting method would be limited to firms which have average annual gross receipts (over three years) of $5 million or less and do not use any other accounting method regularly to determine income, profit or loss.

Under the accrual method, generally speaking, income and expenses are recognized and deducted when incurred; the cash method recognizes income and deducts expenses when they are received or paid in cash or equivalent.

These new cash accounting restrictions would be effective for taxable years beginning January 1, 1986. However, taxpayers would be permitted to spread the income adjustment that results from the switch between the two accounting methods ratably over a six-year period.

The rationale offered for this provision in the Administration package seems plausible on the surface but does have its weak spots. The Supreme Court has recently noted that there is no implicit presumption that financial accounting and tax accounting should be in conformity. In Thor Power Tool Co. v. U.S. 439 U.S. 522 (1979), the Court stated:

> "The primary goal of financial accounting is to provide useful information to the management, shareholders, creditors, and others properly interested;...the primary goal of the income tax system, in contrast, is the collection of revenue...Given this diversity, even contrariety, of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable."

In addition, it is incorrect to assume that the Administration proposal would necessarily eliminate any discrepancy between the financial statement and the tax return. Even if both were on an accrual basis, signficiant differences, such as depreciation recognition, would remain. In fact, the above discussion on the proposed elimination of reserve accounting for bad debts represents an inconsistent movement in the Administration package away from accrual methodology.

Cash accounting is somewhat of a misnomer. Tax returns prepared on this basis do not completely follow a receipts and disbursements methodology -- depreciation is a non-cash basis spreading of the cost of acquiring fixed assets used in the business. The major problem that Treasury has with the overall approach followed by cash basis taxpayers is the somewhat greater flexibility afforded.

Cash accounting does indeed provide thrifts with some important tax management alternatives not available under the accrual method. Moreover, an abrupt change from cash to accrual accounting would create an additional burden for thrift institutions at a time when they are struggling to restructure their portfolios and recover from the prolonged earnings squeeze which has weakened them. The flexibility provided by cash accounting is important to the continuation and success of this recovery process.

However, even if the prejudice against the overall cash basis of accounting prevails, the League would suggest that a deeper analysis of the situation would argue for, at most, a limitation in the use of this method by savings institutions. The major legitimate reason the Treasury might have for opposing the use of the cash method is its potential for creating timing differences whereby one taxpayer's expense is not simultaneously picked up as another taxpayer's income. If expenses are recognized before income is declared, the Treasury is making interest-free loans of the taxes on the discrepancy.

Even though this may be a valid theoretical concern, for savings institutions the problem does not arise on the vast bulk of the transactions on either side of the balance sheet. As financial intermediaries specializing at the retail, individual taxpayer level, our cash basis business accounts interact with cash basis individual taxpayer returns.

On the savings deposit side, the vast bulk of our liability base, the constructive receipt doctrine and the countervailing deductibility of deposit interest expense as credited to accounts essentially produces a near-perfect match. On the asset side, the preponderance of individual mortgage loans owed by cash basis mortgagors gives an equal offset to our cash basis recognition of income thereon.

Any move away from the cash basis on the bulk of our assets and liabilities would, in effect, produce rather than eliminate the type of distortion intended by the switch to the accrual basis. A clear instance of the asymmetries caused by the accrual basis for our institutions is the problem created by applying the original issue discount (OID) rules to individual mortgage transactions by last year's tax act. (See the U.S. League's statement of April 24, 1985 to your distinguished Committee.)

Under DEFRA, savings institutions would be placed on an accrual basis for certain purposes though borrowers would be limited to cash basis interest deductions. Consequently, lenders would accrue more income than borrowers could deduct as expense. Instituting asymmetries in favor of the Treasury is no solution to asymmetries against the federal revenues.

We appreciate the work done by your Committee and its staff to mediate a solution to the OID complexities raised by last year's tax act. Exactly analogous problems would arise from the present proposal to mandate accrual accounting generally.

The U.S. League recommends that savings institutions be permitted to continue the use of cash accounting for tax purposes. At the very least, this method should be retained for reporting income from long-lived financial assets and the financed interest, origination points and deferred interest thereon. As with the elimination of reserve accounting and reserve recaptures, a significant financial accounting cloud hangs over the reform provision. The financial statement damage could be out of all proportion to the revenue raised.

Finally, and to illustrate the interconnections of these issues, the forced switch to an accrual rather than a cash method of accounting could also require the recognition of taxable income which in fact may never be received. Since income is reported as accrued rather than as received and since specific charge-off, institutions will be forced to pay taxes on fictitious income and defer any reversal of that tax charge until final uncollectibility can be proved. Such provisions can hardly be characterized as a movement towards greater fairness.

EXCESS DEPRECIATION RECAPTURE

A major new element of the revised Administration package is the recapture of 40% of the excess depreciation claimed under the ACRS regime enacted by the 1981 tax act. Treasury argues that the timing difference produced by ACRS will, unless corrected, produce a significant windfall by accelerating deductions into a 40% rather than a 33% corporate tax regime. By triggering 40% of the timing difference of excess depreciation into the taxable income stream at a 33% corporate rate, the 13% difference between the 46% and 33% corporate tax rates is approximately offset.

Many commentators have criticized the meat-axe approach adopted by the Treasury in this area. The detailed criticisms have discussed the importance of the composition of the fixed asset portfolio on which excess depreciation is recaptured and the misapplication of the analysis to assets on which a substantial part of the return will be taxed at capital gains rates. We commend these points to the Committee's attention.

However, as far as savings institutions are concerned, a much simpler point must be made: the entire depreciation recapture process is predicated on a completely erroneous assumption of a 13% drop in the statutory tax rate from 46% to 33%. As far as we are concerned, the reform package as drafted would actually raise our statutory rate from 31.3% to 33%. For savings institutions, the excess depreciation recapture should be eliminated as completely as the recapture of past bad debt reserves. Closer examination of the particular circumstances of our institutions can show no basis for either of these punitive provisions.

As a final matter related to the purchase and expensing of capital assets, in the event that any eventual tax reform legislation does not completely eliminate the investment tax credit (ITC), the League would like to draw the committee's attention to the inequitable treatment of savings institutions in that regard. The special thrift bad debt deduction is now effectively down to only 32% which would already argue for availability of more than the 50% value of the regular ITC currently available to our institutions. Obviously, to the extent that further cutback in this special bad debt provision is contemplated, compensating adjustments in any retained ITC program would be in order.

A similar point could be made as regards the availability of the current 85% and proposed 90% corporation to corporation dividends received deduction. We do, however, appreciate the institution of a limited 10% dividends paid deduction. As institutions increasingly move to stock form, this will offer some relief from double federal taxation of corporate profits.

DELAY REPEAL OF REORGANIZATION RULES FOR FINANCIALLY TROUBLED THRIFTS

A final area as regards our position as corporate taxpayers faced with a major recapitalization and restructuring task relates to special thrift reorganization rules. These rules were enacted in the 1981 Economic Recovery and Tax Act to permit the acquisition of a "financially troubled" thrift to qualify as a tax-free reorganization without regard to the continuity of interest requirement (Section 368(a)(3)(D)). This provision in the revised Administration package would until 1991 continue to permit an acquiring corporation to assume the failing thrifts' assets and liabilities in a tax-free reorganization without regard to continuity-of-interest. The same sunset date is provided for Section 597 which provides for tax-free treatment of certain FSLIC payments made to the acquiring corporation in connection with an acquisition.

These 1981 tax law changes were intended to assist the FSLIC in attracting merger partners for supervisory merger cases -- thus assuring depositors that their funds were secure and minimizing payouts from the FSLIC fund. Thrift institutions remain exposed to interest rate fluctuations and are still only part-way through restructuring their balance sheets to enable them to compete in the uncertainty and volatility of the newly deregulated financial environment.

The U.S. League fully agrees with the President that the thrift industry has not fully recovered from the devastation of the 1981 and 1982 loss years. We, therefore, strongly support the President's decision to delay repeal of these important supervisory assistance Sections at least until 1991.

In fact, we would prefer Congressional review at that point rather than a definite sunset. Currently, we project rather healthy earnings in the aggregate for the business for 1985 and beyond but should a breakdown in the budget process unsettle financial markets and increase rates sharply, these projections could quickly require a downward adjustment. In addition, even though the business on average may rebound rather strongly, the FSLIC caseload may be slower to shrink and a hard and fast target of 1991 may be impossible to meet.

As a further point, we see no rationale for confining this type of merger facilitation to the FSLIC alone rather than to both FSLIC and FDIC assistance for troubled thrifts. Given the strains placed on the FDIC by the past few years, we would strongly support extension of these provisions to the FDIC assistance payments already made in the past and to be made in the future. Uniformity in these rules for all thrifts would be one beneficial example of tax code neutrality.

FEDERAL DEDUCTIBILITY OF STATE & LOCAL TAXATION

Finally, we come to the interaction of the proposed changes in individual tax laws with the position of savings institutions as financial intermediaries. The key issues here involve the federal deductibility of taxation imposed by lower levels of government.

A great deal of discussion has involved the impact on real estate values of the denial henceforth of the deductibility of local property taxes. The U.S. League shares these concerns as will be outlined in a moment but first it may be helpful to analyze another, little-appreciated implication of the non-deductibility of state income taxes.

Non-deductibility of these taxes will inevitably disadvantage all forms of taxable debt instruments vis-a-vis U.S. Treasury and agency obligations. Presently, wherever state or local income tax is levied, interest on federal obligations is exempt, just as municipal bond interest is in turn exempt from federal taxation. Savings accounts, though of virtually equivalent safety in view of the federal guarantee, must pay a somewhat higher rate, other things being equal, to cover the double bite of taxation imposed at both the state and federal levels.

That savings account rate spread to the equivalent maturity along the Treasury yield curve is narrowed by the federal deductibility of the state tax bite on the savings account interest. In effect, the federal tax bite is reduced in proportion to the marginal tax rate of the investor. If, however, the rules are changed so that no offset to federal tax liability is allowed for the state income tax bite, the yield spreads from doubly-taxed savings accounts to single-taxed U.S. obligations must widen. In effect, all rates must rise relative to the Treasury yield curve.

The net outcome of this phenomenon is hard to predict but it is simple to show that, for a marginal depositor/taxpayer in the 35% federal tax bracket facing 9% state income tax on a 10% savings account, the break-even increase in savings account yield is approximately 0.3%, i.e. a 10.3% yield will now be necessary to prevent a switch to investment in Treasuries.

To some extent, depending on supply and demand conditions in the savings market, this higher cost will come out of improving, but still thin savings institution margins, reducing the accumulation of capital and the ability to provide financing. Also, however, since this is a general phenomenon, the rates on new mortgages will rise, first from attempts to pass along those higher savings costs, and, second, to attract the same level of funds in the now tougher competition with investments in Treasuries.

Intentionally or unintentionally, this provision will enhance the marketability of Treasury obligations at the expense of every other debt instrument, including mortgages. There is no guarantee that the general level of interest rates will fall enough to overcome this adverse impact on housing affordability.

Of course, the loss of the deductibility of property taxes would also adversely affect the after-tax cost of homeownership. Again, there is no guarantee that the presumed decline in mortgage interest rates from increased savings at lower tax rates will more than compensate for the loss of the property tax deduction. Even if interest rates do decline should the package be enacted "as is", that would provide little consolation to current owners facing higher home occupancy expense unless that homeowner has an adjustable rather than a fixed rate loan. A contention that the lower income tax rates would always offset the loss of the property tax deduction is demonstrably untrue. At the very least, in a relative sense, housing would be a less attractive investment.

Certanly it has to be admitted that the exorbitant rates of return on highly-leveraged, fixed-rate financed real estate investment achieved in the inflationary era of the late 1970s could not and should not be sustained. In addition, some of the alarmist analyses of the impact of the loss of the property tax deduction may have gone overboard in predicting massive declines in real estate values. Nonetheless, given the fragile nature of both the housing recovery and the rather high delinquency rate already produced by the slowdown of inflation and the uneven geographic distribution of the recovery from the recession, even a 2-5% decline in relative real estate values could produce additional, unnecessary problems for both borrowers and lenders.

Foreclosures are clearly a human tragedy for the family dispossessed. But they are also a financial calamity for the lender. At a time when savings institutions are finally beginning to recover from the strains of inflation and recession, an added wave of asset quality problems would hardly be helpful.

Nor is the condition of the FSLIC, even with the retention of the special assistance provisions, so strong as to enable additional problems to be handled routinely. Overall, we feel that the impact of the proposals on the real estate sector has been inadequately analyzed by Treasury and is a welcome subject for Congressional review.

Though the property tax deduction has received the lion's share of the attention, the inclusion of mortgage interest on second homes in the $5,000 plus investment income limitation on the other interest deduction may also already have had an impact on housing activity. Although second homes comprise perhaps only 3-4% of total activity, in certain regions the proportion is much higher. Nor are such purchases the exclusive domain of the ultra-wealthy. A further review of this limitation in the Administration package is in order.

The same goes for the revisions in the "at risk" and capital gains rules for commercial real estate. Again, a substantial proportion of rental property has benefitted from these provisions which the reform package would eliminate. An in-depth review of the impact of these changes prior to enactment is essential.

Savings institutions have played an increasing role in financing such properties. Some institutions have been extremely successful; a few have been much-publicized failures. The fortunes of neither extreme, nor of the vast bulk of institutions in-between, would be improved by these changes. Ultimately, the FSLIC is exposed when ventures involving FSLIC-insured institutions are involved.

MORTGAGE REVENUE BOND ELIMINATION AND INSTALLMENT SALES ABUSES

Despite these reservations, the League does support two provisions in the Administration's program dealing with housing. The first is the elimination of the disruptive mortgage subsidy municipal revenue bond program. Though superficially attractive as a means of assisting the first-time homebuyer, these programs have been costly to the federal Treasury, inefficient providers of deep subsidies to a favored few, and insufficiently targetted to families needing special assistance for home purchase. If homeownership subsidy programs are to be continued, our League advocates more extensive use of the direct Mortgage Credit Certificates program authorized under DEFRA. That alternative provides a greater degree of borrower choice of both lender and loan type, and produces a more equitable dispersal of federal tax subsidy.

The second housing-related area where we endorse the Treasury package is in its revision of the installment sale rules. So-called "builder bonds" permit a lengthy deferral of taxation on profits from real estate sales, even though the builder/developer is effectively cashed out of the mortgage financing afforded to purchasers, because of the retention of the mortgage by the builder for legal, if not economic purposes. This practice represents a clear abuse of the permissible choice of tax accounting method and is overdue for correction.

SUPPORT FOR LOWER GENERAL CORPORATE RATES

The U.S. tax code has always been voluntary and, therefore, compliance becomes a critical factor in measuring efficiency and fairness. Without fairness and perceived equity, tax code compliance will be quickly eroded. Examples of tax code non-compliance, however, seem to be on the increase and, therefore, the U.S. League supports effective measures to improve compliance and reduce the growing underground economy.

An important element for improving tax code fairness, simplicity and compliance is the reduction in overall corporate and individual tax rates. Easing the perceived tax burden through lower rates improves voluntary compliance, reduces the attraction of shelter provisions and other tax avoidance schemes, and simplifies the existing code. We applaud the Administration for proposing lower corporate tax rates. Reduced corporate tax liability will in our view increase taxpayer compliance and stimulate economic growth.

SUPPORT FOR SPOUSAL IRA CHANGES

The U.S. League also commends the President for his proposal to expand the spousal IRA contribution to the maximum $2000. The American housewife who usually works more than a full day in the home should not be denied the same retirement benefits of a wage earner working outside the home. The IRA account is one of the major inducements for long-term savings and spousal IRA parity will increase this important source of long-term capital.

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This concludes the written testimony of the U.S. League of Savings Institutions. Our organization supports the Administration's recommendation for a maximum 33% corporate tax rate. We cannot, however, support the elimination of the thrift institution bad debt reserve (Section 593) and its replacement with a specific charge-off for bad debts. In particular we protest as unfair the Administration's proposal to recapture a portion of accumulated bad debt reserves. With regards to the net operating loss carryback/carryforward treatment of savings institutions, we recommend continuation of the 10-year carryback and extension from five to eight years of the carryforward to achieve parity with the 18-year duration of carryback/carryforward now available to other corporations. The Administration's recommendation for mandated accrual tax accounting is inappropriate for depository institutions. The proposed elimination of the deduction for State and local taxes creates a special problem for private-sector financial intermediaries in the competition for retail deposits with U.S. Treasury issues. We were pleased when the Administration eliminated immediate repeal of special sections of the Code needed by the FSLIC in its resolution of supervisory cases; however, we urge your Committee to review the continued need for these provisions, rather than "sunset" them, in 1991. Finally, we call your attention to the work of House Banking Committee, which has pending for floor action legislation redefining a "qualified thrift lender" for the purposes of the financial institution statutes. Ideally, a consistent qualifying assets standard should apply for corporate tax purposes, as well. The U.S. League recommends deferral of fundamental savings institutions corporate tax revisions until Congress establishes a framework for the future of specialized thrift institutions in the laws governing financial institutions.

I have appreciated this opportunity to present the views of the U.S. League of Savings Institutions and look forward to your questions.

Senator GORTON. Mr. Schmidt.

STATEMENT OF DAVID SCHMIDT, CHAIRMAN OF THE BOARD, COULEE DAM CREDIT UNION, COULEE CITY, WA, ON BEHALF OF THE WASHINGTON CREDIT UNION LEAGUE

Mr. SCHMIDT. For the record, I am speaking on behalf of the Washington Credit Union League which wasn't quite on the agenda, and I am not sure that is real important.

Credit unions are currently tax exempt, and they are covered in this proposal. Under the proposal, credit unions in excess of $5 million would be taxed basically at 33 percent of net income.

There are several really difficult issues that come into play, and I don't think any of them are really money. Credit unions, because of the type of loan business they are in, have very short-term assets, and I believe that credit unions can adjust to paying taxes in a short period of time. I think the real issue gets down to one of safety and soundness of credit unions, and that safety and soundness sort of pivots off of the corporate structure or how credit unions are put together.

They are unique in that they are cooperatives. They are started without risk capital. They are started generally by a group of consumers who are looking for their own unique type of financial institution that they can own and have some control and have some say about how they want to deal with their own finances under the Federal Credit Union Act or, in the State of Washington, the State act.

Credit unions have been tax exempt for in excess of 50 years. I think it is a little simple to say that you could throw this same tax on credit unions and continue the existence of credit unions under the same structure that they are now which is really a matter of safety and soundness.

Credit unions are required to set aside reserves, as are other financial institutions, because we obviously take on risks in the markets that we are in. Fluctuating interest rates really create a need for a lot of risk capital.

Senator GORTON. How would the fundamental structure have to change? These two gentlemen who preceded you have been subject to taxation and have had reserves and the like.

Mr. SCHMIDT. I guess the real hard part, myself, trying to reconcile how that structure would change—as credit unions grow and expand, their need for capital grows and expands. The kinds of services and the way that we are limited in making money under our current structures, the more you tax it, the faster you have to turn the wheel on the bottom line and the more you do that, the more you have a need to create that capital. There is no other source for capital except for retained earnings or net income for credit unions. There is no risk capital, whatsoever, in the formation of it.

Senator GORTON. So, you grow a great deal more slowly than you are now, but is that a fundamental structural change?

Mr. SCHMIDT. I guess I would look at historical—at what the thrift industry is. Problems come because you go through those cycles, and you get a lot of fast growth and you start outgrowing your reserves, and you are in that marketplace that somebody is going to come along and say, well, maybe there is another option that is needed. I sort of have a feeling that what lies in the future is a change in the Federal Credit Union Act and, generally, that follows down to State levels, and that is to say, OK, here is an option in that stock.

Senator GORTON. OK. I am sorry to have interrupted you. Go ahead.

Mr. SCHMIDT. Well, that is along the same argument and sort of the line that I am following. It is really hard to debate the issue of credit unions in that general tax category because we haven't been taxed. We are not really sure what the impact of that tax is. As far as the ability to pay the tax, I don't think that is a problem at all.

My only fear would be the uniqueness of the corporate structure, cooperatives, and would that continue into the future, and when the problems start to arise in the future, are they going to say, well, here is your option as a credit union. Now you can issue some stock to create risk capital. As both of these gentlemen were talking about, the accumulation of capital is important and significant.

I don't know and I can't answer the question, can we create sufficient reserves in a tax situation as a cooperative and survive into the future. That is a question that I don't know how that question can be answered because that situation has never happened.

Probably, all the adjustments can be made. What we would have to look at is how is that going to change credit unions. When we find out how that is going to change credit unions, is that what you want. We as an industry, professionals in the industry, really our opinion is useless. We are looking at what credit unions are. They are the people together. They are the ones who own them, and they are going to change for them.

For myself as a professional, it can change, and it doesn't change anything for me at all. I am working in the industry. I will continue to work in the industry, and we will survive. We will just be something different, and we need to know what that difference is. We have sort of been thrown into a bucket with a whole bunch of other worms that have to wiggle, and I don't think we have the right forum to be heard, or to examine, or to explore and try to convince you people who are making the decision that you are going to be making the right decisions for the people who own and belong to credit unions.

That really is the bottom line of what I have to say. There are a lot of statistics that we have submitted that you can look at. They are real dry. I am only looking at it from a philosophical point of view and what changes are going to happen to credit unions as institutions and the people who belong to them.

Thank you.

Senator GORTON. Thank you.

Mr. Byrne.

STATEMENT OF JIM BYRNE, DIRECTOR OF GOVERNMENTAL AFFAIRS, WASHINGTON CREDIT UNION LEAGUE

Mr. BYRNE. Thank you, Senator.

I am Jim Byrne, Director of Governmental Affairs for the Washington Credit Union League. Perhaps she has heard me speak before, I am not sure, but when I talked with Gwendolyn about appearing here today, she suggested that if David would have some prepared remarks and Dave and I would be available for questions from the panel, that would be the proper approach. So, I have no prepared remarks to submit and would like to suggest that the panel field whatever questions you might have.

Thank you.

Senator GORTON. Let me go back to the two thrift institution people. I think, Mr. Beeksma, you started out by saying that as definable industry groups, you ranked very close to the top in your presented effective tax rate. I think Mr. Soule said that his service corporation, at least, was taxed at 46 percent. If my memory serves me correctly, that is as high as you can get.

Mr. SOULE. That is correct.

Senator GORTON. You have no way of reducing that income, none at all, under the present set of circumstances. So, of course, your service corporation would have a lower net tax as a result of this proposal, would it not?

Mr. SOULE. Yes, but when I talked about the difference between 28 percent and, I think it was, whatever that higher percent was, that included the service corporation tax, all of our income tax in a 33 percent which brought the two more in line. That is correct.

But the amount of income that we generate through our service corporation is not significant in terms of the amount of income that we generate through our savings and loan.

Senator GORTON. Let me get back to the question. Where do you rank in comparison to the other classes of corporations down here in effective tax rate?

Mr. BEEKSMA. Well, I can't answer that, Senator, except the information we have available to us indicates that our industry is in excess of a 31 percent effective tax rate. That means tax dollars paid as a percent of gross income.

Now, we know that the corporate rates are higher than that, but each industry has its own ways—for example, commercial banks have full investment tax credit. They have municipal bond income and that sort of thing, lots of ways of cutting that down. And the commercial banks presently pay a somewhat lower effective tax rate on gross income. It is 20-some percent. Ours is 31. Of course, the credit unions have none. Life insurance industries are somewhere down.

I can't comment on any other kind of industry, but addressing the financial group, we are the highest from the information that we have available to us.

Senator GORTON. Mr. Schmidt, in your formal testimony, you emphasized very strongly and quite appropriately that a credit union by definition doesn't have outside investors—it is owned by its depositors, by its members—as a justification for not being taxed. But so is Mr. Soule's particular kind of financial institution.

What is the distinction between the two? What rationale is there for taxing his institution and having your tax exempt.

Mr. SCHMIDT. Well, I can't really answer that. I am not really sure why they pay taxes, why credit unions don't pay taxes. If you get into a credit union accounting system, it is as though the institution is nonexistent, and I am sure that Mr. Soule's institution looks somewhat that way.

I really can't answer why that unique situation exists. I believe that originally credit unions dealt with consumers, as they do now, and there was not an adequate source of capital available for consumer lending and that they created a unique tax situation for credit unions to allow them to develop and grow without inserting risk capital because it is unique as a cooperative.

I can't compare us to savings and loans because I don't know their internal makeup or how they are unique or different from us.

Senator GORTON. Ray, can you do so? What is the difference?

Mr. SOULE. Really, as I see the credit unions and the thrifts, we were very much the same many, many years ago. As we developed in theory, we became Federal and much larger over the same period of time, I think, than credit unions. The difference that came about in the early 1950's and then in 1962 or something like that when Congress in their wisdom said, no, we should tax, and there is very little difference between us other than the fact that we are taxed and they are not.

I am not saying that David's should be taxed. It is my personal feeling and our board of directors' feeling that, as corporate citizens, we should pay a reasonable tax. That is in our policy and we believe that, although we want to have an opportunity for that not to be a burdensome thing in terms of being in competition with other financial institutions.

Senator GORTON. But you would not attempt to make a distinction or to have significant tax advantages over Mr. Beeksma's thrift simply because his is a corporation with shareholders and yours is not?

Mr. SOULE. Absolutely not. I think there is no difference between us. There are just natures of our corporations that are different in neutrality and stock.

Senator GORTON. Did you have anything you wanted to add, Mr. Byrne.

Mr. BYRNE. I think we serve a different function. I also would not like to make the argument that savings banks should be taxed while credit unions are not, but I think we are serving different functions. We are serving principally the small consumer lending and small consumer savings markets. We are unable to serve the general public as a result of the way credit unions are chartered. We can only serve a limited segment, typically an employee group or a group within a specified community area. So, we are unable to market to the general public.

There are significant restrictions on the investment activities that credit unions can engage in. I am not specifically familiar with the type of investment activities, for instance, that a savings bank can engage in, but I do know that because of the investment restrictions on credit unions, it would be very difficult for credit unions to continue operating the way we do now if we are taxed.

Senator GORTON. Is there any rationale other than an arbitrary choice in the administration's proposal for including this $5 million in assets limitation below which, presumably, you would retain your current status and above which you would not? Is there any rationale for that kind of distinction at all?

Mr. SCHMIDT. I think I can answer that. I think it is strictly a political issue. I think that in excess of 80 percent of the credit unions are under $5 million, and it is a divide and conquer. If 86 percent don't complain and 14 percent do, it is——

Senator GORTON. Where are you?

Mr. SCHMIDT. We are on the tax side.

Mr. BYRNE. I would like to point out that the smaller credit unions, that is, the credit unions under $5 million in assets, are very concerned about this proposal also. It is not just the credit unions that who would be subject to the tax. We are afraid it would inhibit growth of credit unions which we see as a healthy thing. We are afraid that, due to the value of the dollar over time, the $5 million limit would be approached by most credit unions.

One way of saving financially distressed credit unions is to merge them, often with similar credit unions within an area, and that might create an over $5 million credit union. I think almost unanimously the smaller credit unions are very much opposed to this.

Senator GORTON. If that took place, it would clearly divide the interests of your league, wouldn't it?

Mr. BYRNE. Correct. And as I understand it, the $5 million figure was relatively arbitrarily reached. I don't believe there was a specific reason why they chose $5 million. I have heard some reports recently that the Ways and Means Committee of the House is considering raising it to $50 million. Again, we don't think that would be appropriate, either.

It seems to me that decision right there—to raise the level from $5 to $50 million—indicates that whatever level they are establishing is arbitrary.

Mr. BEEKSMA. If I might comment, Senator, on that recapture of the bad debt which I overlooked the first time, a substantial part of that bad debt reserve right now has already been subject to the minimum tax. To now retroactively tax that again and run it through the income flow would either result in a double taxation on those same dollars or an impossible calculation that I don't know how you would begin to do to get credit for what has already been paid. And that minimum tax, as you know, has been increasing rather substantially.

Senator GORTON. Thank you, all four of you, very, very much. You have been a great help to us.

The third panel is Mr. St. John, Mr. Duzan, Ms. Brazier, and Mr. Wise.

Mr. St. John, you are first on the list, so we will start with you.

STATEMENT OF BILL ST. JOHN, BIO TECHNIQUES LABORATORIES, INC., REDMOND, WA

Mr. ST. JOHN. Thank you.

I am president and chairman of the Board of Bio Techniques Laboratories, Inc., a biotechnology/genetic engineering firm located in Redmond, WA. As a biotechnology company, we develop new innovative bio products for agriculture, for industry, and in the cleanup of toxic waste materials.

I appreciate the opportunity to comment on the most recent administration tax reform proposals. My comments will be solely from the perspective of the high technology industries and address only issues we feel are relevant to our form of industry. I might add that the Seattle area is one of the centers for biotechnology development in the country. Evidence of it is people from the industry on this panel.

Our company, Bio Techniques Laboratories, has followed, I think, very typical sequence of development in the high technology business. Our investors have, over the last 3 years, invested millions of dollars in R&D efforts. These were somewhat risky R&D efforts, and then they invested heavily in the construction of new production facilities, and they have just very recently begun realizing revenues from their investment.

For a company such as ours, the primary concern is access and cost of capital. Capital is absolutely essential to the development of new advanced technologies. Without the availability of large amounts of capital, the high technology business would very much suffer.

Looking at the most recent tax reform proposal as a whole, its impact on the cost and availability of capital will not be devastating, will probably not be traumatic. However, it can't be viewed as a positive. It offers no real stimulation for investment in the high technology industry.

The investors in the high technology industry take a disproportionate amount of risk. Capital gains makes the risk to reward ratio worthwhile and appealing. For this reason, the high technology industry as a whole, I think, endorses very enthusiastically the retention of capital gains.

Retention of capital gains is absolutely necessary for sustaining a pool of venture capital for the development of the high technology industry. I strongly urge the committee to resist any effort the shape further the difference between the rates on long-term capital gains and the rates on other incomes.

I also urge you to reexamine the loss and limitation of certain tax credits which will increase the cost of capital during critical stages for the development of our industry. The loss of the investment tax credit [ITC], hits the biotechnology industry at a particularly difficult time. Right now, we are scaling up into production. This is an expensive time for us and a time of large expenditures. The investment tax credit reduces the cost of this process. A major mechanism of financing this is through leases. Our leases become much more expensive without the ITC.

There are other tax credits which are proposed to be eliminated, the orphan drug credit which I would say about 70 percent of the products under development by our industry require some sort of FDA clearances. The cost of this investment will surely be higher with the elimination of ODC. The elimination of the employee stock option plan, the ESOP tax credit. Employee stock option programs are a necessary component of the biotechnology and the whole high technology industry. They have become a standard feature and are necessary to attract highly qualified people away from large established companies into more risky startup ventures.

On the positive side, the extension of the R&D tax credit is viewed as a step in the right direction by the industry as a whole. I think it is a first step to make the R&D tax credit more effective and should be made permanent so that it lends itself better to long-range R&D planning. Its application should be broadened to limited partnerships as well as developmental phase corporations.

In conclusion, for the high technology industry, the proposed changes in the tax law represent somewhat of a minor setback from the status quo due to the loss of certain tax credits. But it should be noted that they also offer no real stimulation for investment in our industry. Tax incentives to the high technology industry is a wise investment in our Nation's future, and we call for tax laws that promote vigorous economic growth in our sector of the economy.

Thank you.

Senator GORTON. Thank you.

Mr. Duzan.

STATEMENT OF STEPHEN A. DUZAN, PRESIDENT, IMMUNEX CORP., SEATTLE, WA

Mr. DUZAN. To some degree, Mr. St. John has covered a fair amount of what I had intended to cover today. I will skip quickly through some of the things that he talked about. The thrust of what I wish to talk about also is capital.

I am the president of Immunex Corp. We are involved in a different segment of biotechnology from that of Biotechnics. We are engaged in activities relating to the creation of therapeutic drugs for human usage. We are working with the human immune system which, in its normal state, functions well and protects people from disease rather handily. By utilizing the cells of that system, we hope to treat people whose systems are not effectively working. We will use those treatments for cancer, for immune deficiency, and such things as antimmune diseases, rheumatoid arthritis and multiple sclerosis.

In order for us to do what we are doing, enormous sums of capital are required. I brought along today some examples of that.

We have, to date, developed about 46,000 square feet of facilities in Seattle for the pursuit of our work. That was done at the cost of some $6.5 million, which, for a corporation of barely 4 years in age is a huge investment.

Second, speaking about attracting highly qualified people, stock option plans are helpful, but beyond that, the cost of employing those people is also very high. Our average employee is under 30 years of age and makes more than $30,000 per year. Our total payroll for 115 people, exclusive of fringe benefits, now exceeds $3 million annually.

Because of the very long period of time before we can possibly be profitable—and the reason for that is simply that all of our products have to pass through the FDA for approval and that is a very time consuming process, as you know well—we will be losing on the order of about $2.5 million per year for at least the next couple of years. We have already lost approximately $4 million cumulatively to date. All of those losses have to be made up out of capital, and all of those people that we have put together to pursue our objective, some 30 of which hold Ph.D's, have to be paid.

Lastly, as Mr. St. John suggested, our industry has arrived at the point where it is now building its manufacturing facilities. The first stage of the research and development portion of our work is nearing an end. We have one drug today in clinical trial, one entering clinical trial at the end of this year, and a third one about a year away from that point. So, in a very short period of time, the number of important, potentially large drugs that we have developed will exceed that which comes out of a typical pharmaceutical company over a comparable period of time. Yet, we did it with far less dollars, almost all of which comes from investor or equity capital.

All of this information, then, leads to an obvious defense of capital gains. I don't believe it is possible that Immunex or Biotechnics or any of the other companies that are doing this kind of work, not just in biotechnology but across the spectrum of technology, could do so without the availability of capital gains.

We have raised a total of $21 million in the equity marketplace. Of that, about $4 million, the initial $4 million, came from venture capital. I do not know a single venture capitalist who does not state flatly that capital gains are essential to the formation of the pools of venture money that is used to invest in companies like ours. We have raised the balance of our funds from the public marketplace in the form of an initial public offering in July of 1983. I do not believe that investors, institutional as well as individual investors, are likely to enter that marketplace for stocks as risky as technology issues of our kind unless capital gains are maintained.

Mr. St. John did not touch on the taxation of dividends, the proposed favorable treatment under the administration proposal. I want to oppose that. I believe that the large corporations today are not having a problem raising capital in the marketplace. I think this measure largely is a tool of use in the equity marketplace——

Senator **Gorton**. Your view is that that would distort in favor of paying dividends as against accumulating both for investment and for greater capital gains?

Mr. **Duzan**. Correct, yes. I believe it will. And I think the result of that is that major corporations will have an easier time of raising capital vis a vis the small, not yet profitable and, therefore, not dividend paying corporations.

Maintenance of the investment tax credit and also of accelerated depreciation are both essential to the equipment acquisition in our industry. I had our chief financial officer do some exploring of the impact of those items on the leases that we have been able to arrange on our equipment, and just the ITC credit alone means the difference of some 400 basis points in the cost of money for leasing equipment. Accelerated depreciation nearly doubles that figure.

A year and a half ago when we were arranging leases for an expansion of our facilities, our effective cost of money after ITC and depreciation credits had been extended to the lessee was on the order of about 5.5 percent. The differential was obviously those credits, and clearly that is what made it possible for us to expand to the present square footage that we occupy. Without that, we could not have done it.

I would like to also endorse the preservation of the interest expense deduction and maintenance of the research and development tax credit. Last year, the research and development tax credit amounted to about 5 percent of our total expenditures for R&D.

I would also like to comment, not so much as President of a biotechnology company, but simply as one who is pursued all the time by states across the nation who want us to locate our production facility here or there, that I favor the elimination of the favorable treatment of revenue bonds for industrial development purposes. I believe that those are being used at this point in time recklessly, foolishly, and not in the public interest, to try to lure corporations across state lines. I would dearly love to have those dollars made available to our corporation. Perhaps they will be. But speaking as a private citizen, I am appalled at the way they are used.

Senator GORTON. Are you telling me that, in your view, they don't really have the impact of increasing overall industrial development of the United States but simply distort the location of capital?

Mr. DUZAN. That is about all they do. Correct. And I don't believe they are a very effective tool in the end. They have so proliferated that I don't think they are a very effective tool any more in attracting industry into areas perhaps, that are in dire need of it.

One firm in our industry has just built a $10 million facility in the State of Illinois almost entirely funded with that kind of thing. That firm has about $40 million in the bank. While that money, I am sure, can be wisely used in research and development, I am not sure that the State of Illinois and the City of Chicago were in dire need of that facility at this point in time any more than any other area of the country. The firm that got that arrangement is from California, so it is an interesting movement on their part.

The last thing that I would like to appeal for is some stability in the tax structure. Immunex is about 4 years old. I think at least three of the areas that I have commented on today have either been reformed or simplified during our brief existence. If you all could just drop this subject for a while after this year, I think that would be perhaps the greatest service you could perform to the small corporations.

Our task and our role in the industrial segment of America is difficult enough in terms of planning and trying to allocate our capital without having to constantly make switches in our approach and our strategy based upon changes in tax codes that seem to occur annually now, and which are almost beyond our ability to follow.

Thank you.

[The prepared statement of Mr. Duzan follows:]

PREPARED TESTIMONY

ON

FEDERAL TAX REFORM

by

Stephen A. Duzan
President
Immunex Corporation

before

The United States Senate Small Business Committee
Seattle, Washington

August 19, 1985

Mr. Chairman, Members of the Committee:

My name is Steve Duzan. I am the President of Immunex Corporation, a Seattle-based biotechnology company which is engaged in the research and development of new types of therapeutic drugs. Our work involves particular cells of the immune system which, in a healthy human body, turn on or off our various natural defenses against infection and disease. We are utilizing these naturally occurring materials in an attempt to create entirely new types of treatments for illnesses ranging from immune deficiency and cancers to rheumatoid arthritis and multiple sclerosis. Though we are but four years old, we already have one drug in broad based human clinical trials, one on the threshhold of such trials, and another perhaps one year away.

In order to pursue our goals, it has been necessary that we raise substantial sums of capital.

> First, the nature of our work requires that we maintain state-of-the-art laboratories. Immunex has spent $6.5 million dollars to build and equip some 30,000 square feet of ultra-modern facilities.
>
> Second, it is necessary that we be able to attract highly qualified, very specialized scientific personnel: molecular biologists; protein, cellular and membrane biochemists; cellular

immunologists; and the like. We currently employ 115 people, the vast majority in research positions. Over 30 of our employees hold Ph.D.s. Our average employee is under 30 years of age and earns over $30,000 per year. Our annual payroll, before fringes, exceeds $3 million.

Third, the FDA drug approval process involving extensive clinical trials assures that we will be in existence for more than five years, before we are profitable. In the meantime, we "lose" a substantial sum of money in our operations each year. Last year alone our deficit was in excess of $2.5 million. That and losses in previous years were also covered with capital funds.

Fourth, our next phase of corporate development is at hand, the building of manufacturing facilities, which will require yet another major capital outlay amounting to several million dollars.

I cite this information in order to establish a basis for my remarks on the current proposals for federal tax reform. The key to the creation of Immunex, and hundreds of other firms of similar size and promise, is capital. The key to the formation and availability of capital is the federal tax code. The decisions you and your colleagues make regarding tax revision will greatly influence the ability of Immunex and like concerns to achieve their goals and to become larger, successful enterprises.

Because of the critical way the tax code impacts capital formation, I will confine my remarks today to this aspect of the proposed reforms.

Capital gains treatment is the initial area I would like to discuss and the single most important. To date, Immunex has raised equity capital totalling approximately $21 million. Of that, the initial $4 million came from Venture Capital Limited Partnerships. The balance came from the proceeds of an Initial Public Offering in July 1983. Immunex is and always has been a highly risky investment proposition. I do not believe either venture capital or public market funds would be available to the Immunexes of this country without capital gains treatment of future profits on our stocks. Earlier proposals in this round of reform which would have increased the levels of taxation on capital gains were alarming. The administration's current proposal restored sanity in this area, and even proposes a more favorable treatment. The more favorable approach is nice, but not necessary. However, whatever you do in tax reform this year, don't make capital gains treatment less favorable. It is critical.

Next, I want to oppose the proposed reduction in the taxation of dividends. That favors big, established, successful corporations at the expense of the small, risky, emerging ones. They don't have trouble raising capital. We do. This proposal further stacks the deck in their favor. It is not necessary. It is potentially detrimental.

Maintaining the Investment Tax Credit and the favorable impact of accelerated depreciation are very important to small firms like Immunex. We are typical of many startups with long lead times to profitability. We have financed our equipment with leases; leases which are affordable because of ITC and depreciation retention by the leasee. Elimination or reduction of these provisions would restrict our ability to obtain affordable equipment, which would retard our research and reduce our employment. Our Chief Financial Officer estimates that loss of the ITC will raise our lease financing costs by at least 400 basis points.

I would also like to endorse preservation of the interest expense deduction and the R&D tax credit. Both are vitally important to capital formation for new technology enterprises.

Perhaps it is heresy to do so, but I would, at the same time, be in favor of the proposal to restrict tax exempt status for Industrial Development Bonds. Too often these have been abused, and they are foolishly fueling the fires of competition which rage between the economic development departments of various states and localities.

Finally, I would like to appeal, not for simplicity as much as stability. Whatever is done with taxes this year, could we then drop the subject for awhile? The rules keep changing, annually it seems. Several of the areas I've discussed today have already been "reformed" or "simplified" once or twice during Immunex's brief existence. Our financial planning is perilous enough without having to deal with a constantly changing federal tax code and all the ramifications that go with it.

America is the leader in many sectors of the technological revolution which is sweeping the world. Certainly in my industry, biotechnology, that is the case. The firms at the cutting edge of this revolution are not large. They are, in fact, for the most part, very small and precarious. Yet, they represent a major element in the economic future of this country...as innovators and as employers. Be very careful of them...of us...in your quest for tax simplification. The big firms will take care of themselves, regardless. But, you have the capacity to greatly help or greatly hurt the smallfry. We hope you don't forget that, and that the final product of this particular round of tax reform will, in fact, be fair.

Thank you.

Senator **Gorton**. Thank you.
Ms. Brazier.

STATEMENT OF NONA BRAZIER, PRESIDENT, NORTHWEST RECOVERY SYSTEMS, INC., FEDERAL WAY, WA

Ms. **Brazier**. Thank you, Senator Gorton.

I am from Northwest Recovery Systems, Inc. We are a small Washington S corporation, closely held by myself and my husband, Martin. We are 3 years old, dealing in analysis, cleanup, transportation, and disposal of semihazardous and nonhazardous waste. Ours is a labor intensive and capital intensive business. As an example of that, all of my employees are in their midtwenties to midthirties, and all of them make in excess of $30,000 a year.

I am Nona Brazier. I am the president and general manager. I will speak briefly on the ITC, depreciation, entertainment expense, and corporate tax rates, with an eye on equity, neutrality, and simplicity. But there is a major difference in large established businesses and a small beginning business venture. Sometimes, neutrality and equity require diversity of treatment. As for simplicity: I am a graduate of the University of Texas at El Paso. I have some graduate hours. I have been in the work force for 20 years, since I was 16. I have a great husband, seven children, one of which is in the 82d Airborne at Fort Bragg, and I possess, I think, an above-average intelligence and a pretty good business sense. But our tax system is so complicated that actually it was necessary for me to consult with my accountant in order to make a comment on the proposals much less to enact any of these. Even now, I think that I would need at least three accounting courses in order to be secure in the opinions that are voiced.

If you will please just weigh these comments against some fundamental beliefs. First of all, I believe that a capitalistic economic system is the most efficient and fulfilling expression of man's productivity and that our capitalistic system should be controlled by the marketplace. I also believe that the purpose of taxation is to be a vehicle through which businesses and individuals equally support our democratic government as it provides for the public defense, cares for those who are sick, frail, or too disabled to care for themselves, and seeks to compensate for some inequities of past legislative discrimination.

As far as the investment tax credit is concerned, the unanimous opposition to the investment tax credit comes from one point of view. The idea that business is being rewarded for purchases it would make anyway presupposes that a business is established and able to update its equipment to become even more competitive within its market. It does not take into consideration at all the role that the ITC has made in allowing the entrepreneur to begin his business and then to expand his business slowly out of the smaller stages and establish himself.

There is sound reasoning why, as one of the professors earlier noted, of 93 percent of small businesses with a gross of $5 million or under that 80 percent of these are in the service sector; because the capital involved in trying to capitalize in manufacturing and other industries is prohibitive to small businessmen.

The small business does not have the luxury of making skewed investment choices or inefficient economic choices based on tax policy, but the ITC has made it more economically feasible to make necessary business moves that would otherwise have had to go unmade. The ITC is one of the few inducements for investing personal money into business equipment and is one of the only credits available to small businesses.

For instance, few small businesses will ever be able to take advantage of the foreign tax credit. Also, the ITC should only take into account the actual money invested rather than whether or not the equipment is new or used. Used equipment is a mainstay for the small beginning business. That is, more often than not, kept alive on a wing and a prayer coupled with the blood, sweat and tears of the owner.

As to depreciation, the accelerated cost recovery systems as established in 1981 was under pressure from big business. The system is a farce, and the capital cost recovery system is also a farce in that it has no relationship to any day-to-day reality that the small businessman can put his hands on. We need to go back to a standard of depreciation as established within standard accounting practices.

To deal with the ACRS, the small business person will have to hire someone to stay on top of all the indices and the alternations. Its complexity, while giving leverage to large businesses, works to the detriment of small businesses. And the adjustment for inflation allows a disproportionate advantage to big businesses which are able to invest larger amounts on equipment. Without adjusting for inflation, two businesses are in equal position, each being able to receive depreciation allowances based on what has gone out of pocket. With the adjustment for inflation, replacing the declining balance with the straight line method when it is most advantageous and applying a series of intangibles, a big investor is able to realize advantages that are not at all equally available to the small businessman.

As to the entertainment expense, we have all heard the horror stories about the abuses by business of this deduction. Though it may be abused by corporate giants, the cost of entertaining is a valid and necessary expense to the small businessman who must make contacts in order to acquire the business that he needs to establish himself and his reputation. One- and two-man operations do not have large advertising budgets available to them. They promote themselves and their businesses by continual personal contact and word of mouth. Entertainment is a valid expense for the small businessman seeking clientele even if it has been abused by big businesses just trying to keep its established clients happy.

The corporate tax rates in each of the proposals are less than ideal for what I will refer to as that second stage small business, the one that has made one step beyond its beginnings and just moved out of S corporation status. It takes a lot in the latter part of the 20th century to be a solid and healthy business. A gross income that 15 years ago made you a staggering success story today just barely keeps your head above water.

The corporate tax brackets, seemingly, have not taken this into consideration. It is somewhat ludicrous that, on a progressive tax schedule, a business grossing $2 million per year would be subject to the same brackets as one grossing $2 billion per year.

The small or intermediate business has neither the personnel nor resources to so structure its affairs as to avoid the tax liabilities in the manner that is available to big businesses. It is the small business, then, that is hit with a disproportionate tax burden in relationship to its size. Anything short of a flat rate on gross income leaves the successful small businessman at a disadvantage in a society that sees business as the enemy to be controlled and that allows big resourceful businesses to manipulate those controls.

The rates on corporate and individual income should be lower than the current. Still a greater concern is the deductions allowed to big businesses that are not within the reach of small businesses. Small businesses are the livlihood of their owners, but they seldom afford them the opportunity or the income to set up sophisticated, lucrative retirement or pension or benefit plans like servancy plans or VEBA's and write them off as a cost of doing business.

Small business is the backbone and lifeblood of our country's economy. We at Northwest Recovery Systems, Inc., seek only to see a tax policy that is used not so much to structure economic policy and mold the marketplace but rather to assure that all businesses and individuals pay their fair share to support the Federal Government.

At this point, Senator Gorton, if the Treasury's plan is a plan that can be enacted, even though there are inequities for some people and there are inequities for others; but if it is a plan that can be enacted and people are comfortable in living with it for a while, we would be more than happy to see that. For a small business person like myself, all we need is to have reality established, and we can deal with it and not have it change on us, not have the rules altered as the game goes on.

[The prepared statement of Ms. Brazier follows:]

NORTHWEST RECOVERY SYSTEMS, INC.
P.O. Box 4856, Federal Way, WA 98063

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UNTED STATES SENATE SMALL BUSINESS COMMITTEE HEARING - SEATTLE

We are Northwest Recovery Systems, Inc., a small Washington S Corporation. We are three years old; dealing in the analysis, clean-up, transportation and disposal of semi-hazardous and non-hazardous waste. Ours is a labor and capital intensive business. I am Nona M. Brazier, president and general manager, and will speak briefly on the ITC, Depreciation, Entertainment Expense, and Corporate Tax Rates; with an eye on equity, neutrality and simplicity. There is a major difference in large established business and small business. Sometimes, equity requires diversity of treatment.

INVESTMENT TAX CREDIT.

The unanimous opposition to the ITC comes from one point of view. The idea that business is being rewarded for purchases that it would make any way presupposes that a business is established and able to update its equipment to become even more competitive within its market place. It does not take into consideration at all the role that the ITC has made in allowing the entrepreneur to begin his business and then to expand his business slowly out of the Ma/Pa stage and establish himself. Small business does not have the luxury of making skewed investment choices or inefficient economic choices based on tax policy; but the ITC has made it more economically feasible to make necessary business moves that would otherwise have had to go unmade. The ITC is one of the few inducements for investing personal money into a business and is one of the only credits available to small business. For instance, few small businesses will ever be able to take advantage of the Foreign Tax Credit. Also, the ITC should only take into account the actual money invested rather than whether or not the equipment is new or used. Used equipment is a mainstay for the small, beginning business that is, more often than not, kept alive on a wing and a prayer coupled with the blood, sweat and tears of the owner.

DEPRECIATION

The Accelerated Cost Recovery Systems was established in 1981 under pressure from big business. The systems is a farce. The attempt to modify it with the Capital Costs Recovery Systems is also a farce in that it has no relationship to any day-to-day reality that the small business person can put his hands on. We need to go back to the old standard of depreciation as established within Standard Accounting Practices. To deal with the ACRS, the small business person will have to hire someone to stay on top of all of the indices and alterations. Its complexity, while giving leverage to large businesses, works to the detriment of small businesses. The adjustment for inflation allows a disporportionate advantage to big businesses which are able to invest larger amounts on equipment. Without adjusting for inflation, two businesses are in equal positions, each being able to receive depreciation allowances based on what has gone out of pocket. With the adjustment for inflation, replacing the declining-balance rate with the straight-line method when its most advantageous and applying a series of intangibles, the big investor is able to realize advantages that are not at all equally available to the small businessman.

ENTERTAINMENT EXPENSE

We have all heard the horror stories about the abuses by business of this deduction. Though it may be abused by corporate giants, the cost of entertaining is a valid and necessary expense to the small businessman who must make contacts in order to acquire the business that he needs to establish himself and his reputation. One and two-man operations do not have large advertising budgets available to them. They promote themselves and their businesses by continual personal contact and word-of-mouth. Entertainment is a valid expense for the small businessman seeking clietele even if it has been abused by big business just trying to keep its established cliets happy.

CORPORATE TAX RATES

The current corporate tax rates and each of the proposals are less than ideal for what I will refer to as the second- stage small business: the one that has made one step beyond its beginning and just moved out of S Corporation status. It takes a lot in this latter part of the twentieth century to be a solid, healthy business. A gross income that fifteen years ago made you a staggering success story today only keeps your head above water. The corporate tax brackets,seemingly, have not taken this into consideration. It is ludicrous that, on a progressive tax schedule, a business grossing two-million dollars per year would be subject to the same brackets as one grossing two-billion dollars per year. The small or intermediate business has neither the personnel or resources to so-structure its affairs as to avoid the tax liabilities in the manner that is available to big businesses. It is the small business then that is hit with a disproportionate tax burden in relationship to its size. Anything short of a flat rate on gross income leaves the successful small businessman at a disadvantage in a society that sees business as the enemy to be controlled yet allows big resourceful businesses to manupulate those controls. The rates on corporate and individual income should be lower than the current. Still, a greater concern is the deductions allowed to big businesses that are not within reach of small business which are the livlihood of their owners but which never afford them the opportunity or income to set up sophistiacated, lucrative retirement or pension or benefit plans like Servancy Plans or VEBA's and write them off as a cost of doing business.

The small business is the backbone and life blood of our countries economy. We at Northwest Recovery Systems, Inc. seek only to see a tax policy that is used not so much to structure economic policy and mold the market place but rather to assure that all businesses and individuals pay their fair share to support the Federal Government.

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For the sake of maintaining our perspective, I would like to submit the following poem by L. Lundquist, 1983:

SMALL BUSINESS PRAYER

We have many situations here, Lord,
That we need you to bless.
The complexities of business grow
While the profits, they get less.

We pray for special wisdom , Lord,
For how to sell and to promote,
For how to work with one another,
For how to keep this thing afloat.

You multiplied the bread and fish
And made lame limbs to grow.
Could you help us with these over-dues,
And touch our sick cash flow?

Though we claim to know the trade, Lord,
We humbly must confess,
That without your help and council
We'd only make a mess.

Thank-you for the opportunity to testify before this hearing.

Nona M Brazier

NONA M. BRAZIER

Senator GORTON. Thank you.
Mr. Wise.

STATEMENT OF GORDON M. WISE, MAMCO MANUFACTURING, SEATTLE, WA

Mr. WISE. Due to time constraints, I am going to limit my comments to basically two subjects: No. 1—and I salute Nona Brazier very much and many of her comments and I thank you for sharing that—the impact of taxation on the major fact of small business which is an really an item called cash flow. Any small business is always struggling for cash.

Our company is called MAMCO Manufacturing Co. We have just recently been awarded the region X small business contract of the year and also Boeing's subcontractor of the year award. I also want to thank you for your personal letter of congratulations.

However, back to the subject of cash-flow, we are 49 years old now, and after 49 years, we have slowly been struggling as a private company owned by individuals only to have a total net worth of just under $2 million. The challenge of cash flow is met every year by the impact as we slowly, slowly grow, we have large demands for capital equipment, large demands for inventory, and large demands to finance accounts receivable.

Each year, as the accounts receivable or inventory grows, it is so frustrating to have to go to the bank and borrow another $100,000 for a $100,000 inventory growth. But then, to compound it to say, ah, that also was $100,000 of profit if your operation is basically level on cash, and then go to bank and borrow another $46,000 to pay the tax on the inventory growth. The net result is we feel we are so often paying a large portion of tax on nothing more than when we are trying to build the corporation. That is not money really made; it is just money sitting in the form of inventory or receivables.

Cash-flow is a very, very major problem to all small businesses. We are struggling to maintain a profitable business, and I feel the reasonable answer has been achieved in past years where for years the tax rate on the first $25,000 of profit was 20 percent and then it jumped over the $25,000 profit area into the higher taxation.

Inflation, of course, has eroded that. We now feel that the indexing for the first $25,000 of profit is relatively too small for the small businessman to handle. It must be of a nature where, say, about the first $100,000 of profit, which will undoubtedly go into inventory or go into the receivable section, should be taxed at a favorable rate of about 15 percent. Then, when you get up to a profit of over, say, $200,000, then you might say you start reaching the category of a larger business where you pay a higher taxation.

Small business must have a reasonable break in the cash-flow lines.

The second comment I wanted to talk about is the investment tax credit area. Again this year, we will invest about $0.5 million in new capital equipment. The tax investment credit is an extremely aggressive item that we look at with major effort to allow us to build this new base.

A few years ago, an average capital equipment piece was $10,000 or $15,000. Now, a new capital piece will run us about $125,000 to $250,000 each. So, the ITC is extremely important.

One way I would like to have considered—this has not been spoken to yet today—is that the ITC also should consider the possibility of American investment. As it is right now, we can invest in a piece of foreign equipment and get a 10-percent deduction, or we can invest in a piece of American equipment and get the same ITC. I would propose that the ITC be favored toward the American equipment.

If we buy a new lathe, as we recently did from Cincinnati Milicron, we will get the 10-percent credit which is, I think, essential. But I am not so certain that the same amount of money we invest in a piece of foreign equipment would have that same preferential treatment in the tax laws. Possibly, a 10 percent on American and maybe a 5 percent on predominantly foreign equipment might be a reasonable solution to encourage not only small business to invest in capital equipment but also to favor the American industries so that the offsetting item will be more jobs for American people and more success for American corporations.

I feel that the ITC is an extremely important thing for the small businessman that is locked into high equipment costs and, therefore, should be retained but, again, with the accent toward American businessmen.

Again, thank you very much for the opportunity to share, and we appreciate being here.

Senator GORTON. I will start this question with you, Mr. Wise, and just go across the table.

Mr. WISE. Yes.

Senator GORTON. If your only choice were to have the President's proposal for tax reform pass in toto or no changes at all, no tax reform at all, speaking both from your perspective as people who are in business and individually, would you advise us to pass the proposal or to reject it?

Mr. WISE. As a category, I would be in favor, but there are also some very, very similar limitations and especially in the investment tax credit area.

Mr. ST. JOHN. I would endorse its passage.

Ms. BRAZIER. That is very difficult, Senator. With the restriction on the investment tax credit, considering how capital intensive we are, I would—to go with the Treasury proposal intact, if we can keep it for a while, I would go with it. I would rather have something that gives me investment tax credit, but I think that where we are now is a transitional stage, and we can't stay there.

Mr. DUZAN. As an individual, I would favor it. As president of Immunex Corp., I don't think that at this point in time I can be in favor of the President's proposal.

Senator GORTON. All right. Now, is it also safe to say, from what I have heard from each one of you, that if you could make one change in the President's proposal, it would be the retention of the investment tax credit?

[Chorus of assenting remarks.]

Senator GORTON. OK, all across the line.

I just have one more question for you, then, as you know, the thrust of this proposal is that it remain at least revenue neutral, so as to avoid making budget deficits worse. What would you be willing to give up, that is, in what area would you be willing to permit higher taxes, in order to retain the investment tax credit, to make up for the revenue loss in this proposal which that would cost?

Mr. **WISE**. That is a difficult question. In the area of small business, I feel that the small businessman is being taxed to the maximum. The area of concern that always irritates the small businessman who is paying about 30 to 40 percent in taxes to see where some very, very large companies with $2 billion of sales paid no taxes last year. I scratch my head and say, now, how in the heck did they do that?

I think there are other areas that need to be looked at in some of the massive credits or diversions that are done by the oil companies and the large defense contractors that is a prime area.

Senator **GORTON**. Ironically, the ITC is one of the major elements which causes that nontaxation.

Mr. St. John.

Mr. **ST. JOHN**. Well, as far as changes in the tax law, I can't point to any that I would give up. I guess the purpose of this whole exercise is a deficit reduction program and making it more fair, too, but I think that is really what we are talking about is revenues. I would cut spending.

Senator **GORTON**. Ms. Brazier.

Ms. **BRAZIER**. Basically, that is very difficult to say, because the small business, again, is at that first stage trying to get off the ground and become competitive. I could even see the investment tax credit being allowable at a certain gross income and then cease to be allowable when you reach a higher level. Perhaps something like that would be more equitable, but something has to happen in order to allow smaller businesses to get off the ground.

Mr. **DUZAN**. Put a ceiling on the investment tax credit in terms of how much deduction is permissible in each year, and make it relatively low, so as to target it at small businesses. If you still must raise revenue, I would do it with the marginal tax rates.

Senator **GORTON**. OK. Thank you all very much. You have been a great help to us, and I appreciate your being here.

Mr. Gordon, Mr. DuJardin, Mr. Crissey, and Mr. Christianson will be our next panel. Jack, we will start with you.

STATEMENT OF JOHN F. GORDON, EXECUTIVE VICE PRESIDENT, RESTAURANT ASSOCIATION OF THE STATE OF WASHINGTON, SEATTLE, WA

Mr. **GORDON**. Mr. Chairman, Senator Gorton, members of the hearing, my name is Jack Gordon. I reside at 6814 44th Place NE., Seattle. I am the general manager of the Restaurant Association of the State of Washington and am also representing the National Restaurant Association here this afternoon. I appreciate the invitation to appear here today to comment from the small business standpoint on the President's and the U.S. Department of the Treasury's proposals to the Congress on changes in the present tax system.

We are in agreement with the National Restaurant Association's position in opposing a limit on deduction for business marketing meals at $25 per person with a 50-percent deductibility beyond this limit. While this affects practically every hotel restaurant and a goodly number of full service restaurants, the $25 limitation is misleading inasmuch as we are told that the usual 15 percent tip or gratuity and the 7.9-percent sales tax as applied in Seattle and slightly less in other cities and counties of this State, the limitation would be closer in fact to $19. Even if the tip and the tax were not a factor, the limit is restrictive.

These full service restaurants and hotels are the biggest employers, and any loss in revenue, coupled with the economic distress we already find ourselves in, would amount to another step towards fiscal disaster.

Much has been said about the favoritism given to bankers, industrialists, and other businessmen and women who do take potential customers out to lunch or dinner and have compared it as discriminatory to plumbers and carpenters and so forth. An analysis of the marketplace reveals that the people who represent plumbing, contractors, builders, construction, and so forth are also involved in this same sales technique, and interference with it by limitations could hurt the overall economy. They produce the jobs for tradesmen and other workers.

We do not feel it is the business of Government to interfere in the marketplace as long as these business negotiations are legal and in accordance with all tenets of honest and good business practices.

We also lament the elimination of the deductibility of business entertainment expenses which include hospitality suites in hotels, receptions, parties, catered events and banquets. This proposal goes beyond just the hotels and full service restaurants and affects nearly every segment of the food service industry. We can see business purchases of tickets for professional football, baseball, and basketball for their customers under the name of promotion and goodwill likewise being affected. This dry-up authorized business promotional expense would also affect our industry inasmuch as on many occasions the sports event does involve dining out.

We also dare to raise the point that such restrictions would adversely affect our industry's ability to host political functions where donations or ticket purchases, often, at the local level, come from the local business community and these same businessmen and women.

As another point, we can see the growth of executive dining room dining or entertainment in competition with free enterprise or the independent restaurant and to the detriment of the industry which recorded $162.8 billion in sales nationally last year and provided some 8 million jobs to help the national economy.

Here in the State of Washington, our industry has some 2,500 full service restaurants with liquor service; some 1,800 taverns, many of which have food; some 2,500 fast food places; and another 1,000 which qualify as delicatessens, vending, school, and campus facilities, health care such as hospitals, community feeding centers, institutions such as prisons, mobile catering, and even gas station and grocery store food service facilities.

In this State, with a population of 4,384,000, some 1,963,000 have jobs, or less than 50 percent of the population. Because some 2,139,000 are considered part of the labor force, we have an unemployment rate of 8.2 percent. The rest of the people fall into such categories as discouraged worker, student, senior citizen, children, housewives, retirees, and so forth. This reduces our potential customer count. We do provide jobs for some 132,000 people on a full-time or part-time basis and do an annual business of some $3 billion in the combined restaurant and hotel industry.

We have seen many new places open and, unfortunately, many close. The closures were due to lack of capital, lack of business expertise, competition, and bad advice. Experts in our industry expect that some 45 percent of today's restaurants face the threat of going out of business if the economy falters.

The national and local economy, the adverse effect of the DWI campaigns which have seen hard liquor sales drop in some situations as much as 20 to 30 percent, and changes in customer preferences as to food have affected over 25 percent of our market. These customers now want fruit, fiber, vegetables, and disdain the one-time American favorites of roast beef and mashed potatoes and gravy. We live in a calorie counting, no salt, no sugar, no fat menu era.

We enjoy a free-enterprise or market atmosphere and don't want to change it. This same free market creates competition which makes constant menu and price evaluation a task for the operator who would be successful. Restrictions on food items containing sulfites, additives, pesticides, sweeteners, antibiotics, caffeine, no smoking laws, and other prohibitions have made daily operations very difficult. Many liquor establishments face excessive insurance costs to protect DWI liability.

Looking again at the President's and Treasury proposals, we express concern over changes in fringe benefits, taxing health plans above a cap, and making group term life insurance and legal services as taxable items. Already we face a big liquor tax increase in October, added restrictions and record keeping of truck and auto use by hotels and restaurants. The removal of deductions for local taxes concerns us as it affects our labor costs and as it reduces spendable income. The taxing of life insurance policies also affects spendable income adversely.

As we look at the State and national economy, we have to share with you some fear that the balance of trade deficit, the huge Federal budget deficit, the $7.145 trillion consumer debt give us cause for great concern. On the plus side, we look forward to Expo 86, the Canadian World's Fair next year, and we hope that some immigration and customs people can be transferred to entry and exit points in British Columbia to speed tourist passage. Again on the plus side, the completion of the Washington State Convention and Trade Center in 1988 holds bright hope for an improving economy.

But in conclusion, and to put it quite frankly, there is an uneasy feeling in many quarters about the direction of the economy, and it takes a new initiative by both State and Federal Government to restore consumer confidence. Some of these proposals being discussed today do not lend themselves to confidence in the future. We do not need a trade war, any kind of war, or even a depression to wake us up and put us on a new track. The statistics at hand give us fair warning that we must do everything possible to keep our economy stable and growing.

The proposals we have reviewed are called a recipe for fairness, growth and simplicity. We agree with the President that the people want change, and a redesigning of the Tax Code would seem to be a step in the right direction, but we have found some sinkholes in that design that need congressional reevaluation so that in moving this country to a new horizon, we have not inadvertently set up chaos for one segment of the economy as a substitute for progress.

I thank you.

[The prepared statement of Mr. Gordon follows:]

AUGUST 19, 1985
FEDERAL OFFICE BUILDING

STATEMENT BY JACK GORDON
EXECUTIVE VICE PRESIDENT
RESTAURANT ASSOCIATION OF THE STATE OF WASHINGTON

MR. CHAIRMAN, SENATOR GORTON, MEMBERS OF THE HEARING, MY NAME IS JACK GORDON. I RESIDE AT 6814 44th PLACE N.E., SEATTLE, AND I AM GENERAL MANAGER OF THE RESTAURANT ASSOCIATION OF THE STATE OF WASHINGTON. I APPRECIATE THE INVITATION TO APPEAR HERE TODAY TO COMMENT FROM THE SMALL BUSINESS STANDPOINT ON THE PRESIDENT'S AND THE U.S. DEPARTMENT OF THE TREASURY'S PROPOSALS TO THE CONGRESS ON CHANGES IN THE PRESENT TAX SYSTEM.

WE ARE IN AGREEMENT WITH THE NATIONAL RESTAURANT ASSOCIATION'S POSITION IN OPPOSING A LIMIT ON DEDUCTION FOR BUSINESS MARKETING MEALS AT $25.00 A PERSON WITH A 50% DEDUCTIBILITY BEYOND THIS LIMIT. WHILE THIS AFFECTS PRACTICALLY EVERY HOTEL RESTAURANT AND A GOODLY NUMBER OF FULL SERVICE RESTAURANTS, THE $25.00 LIMITATION IS MIS-LEADING INASMUCH AS WE ARE TOLD THAT THE USUAL 15% TIP AND THE 7.9% SALES TAX AS APPLIED IN SEATTLE AND SLIGHTLY LESS IN OTHER STATE CITIES AND COUNTIES, THE LIMITATION WOULD IN FACT BE CLOSER TO $19.00. EVEN IF THE TIP AND TAX WERE NOT A FACTOR, THE LIMIT IS RESTRICTIVE. THESE FULL SERVICE RESTAURANTS AND HOTELS ARE THE BIGGEST EMPLOYERS AND ANY LOSS IN REVENUE COUPLED WITH THE ECONOMIC DISTRESS WE ALREADY FIND OURSELVES IN, WOULD AMOUNT TO ANOTHER STEP TOWARDS FISCAL DISASTER. MUCH HAS BEEN SAID ABOUT THE FAVORTISM GRANTED TO BANKERS, INDUSTRIALISTS AND OTHER BUSINESSMEN AND WOMEN WHO DO TAKE POTENTIAL CUSTOMERS OUT TO LUNCH OR DINNER AND HAVE COMPARED IT AS DISCRIMINATORY TO PLUMBERS, CARPENTERS ETC. AN ANALYSIS OF THE MARKETPLACE REVEALS THAT THE PEOPLE WHO REPRESENT PLUMBING, CONTRACTORS, BUILDERS, CONSTRUCTION, ETC. ARE ALSO INVOLVED IN THIS SAME SALES TECHNIQUE AND INTERFERENCE WITH IT BY LIMITATIONS COULD HURT THE OVERALL ECONOMY. THEY PRODUCE THE JOBS FOR TRADESMEN AND OTHER WORKERS.

WE DO NOT FEEL IT IS THE BUSINESS OF GOVERNMENT TO INTERFERE IN THE MARKETPLACE AS LONG AS THESE BUSINESS NEGOTIATIONS ARE LEGAL AND IN ACCORDANCE WITH ALL TENENTS

OF HONEST AND GOOD BUSINESS PRACTICES. WE ALSO LAMENT THE ELIMINATION OF THE DEDUCTIBILITY OF BUSINESS ENTERTAINMENT EXPENSES WHICH INCLUDE HOSPITALITY SUITES IN HOTELS, RECEPTIONS, PARTIES, CATERED EVENTS AND BANQUETS. THIS PROPOSAL GOES BEYOND JUST THE HOTELS AND FULL SERVICE RESTAURANTS AND AFFECTS NEARLY EVERY SEGMENT OF THE FOODSERVICE INDUSTRY. WE CAN SEE BUSINESS PURCHASES OF TICKETS FOR PROFESSIONAL FOOTBALL, BASEBALL AND BASKETBALL FOR THEIR CUSTOMERS, UNDER THE NAME OF PROMOTION AND GOOD WILL, LIKEWISE BEING AFFECTED. THIS DRY-UP AUTHORIZED BUSINESS PROMOTIONAL EXPENSE WOULD ALSO AFFECT OUR INDUSTRY INASMUCH AS ON MANY OCCASIONS THE SPORTS EVENT DOES INVOLVE DINING OUT.

WE ALSO DARE TO RAISE THE POINT THAT SUCH RESTRICTIONS WOULD ADVERSELY AFFECT OUR INDUSTRY'S ABILITY TO HOST POLITICAL FUNCTIONS WHERE DONATIONS OR TICKET PURCHASES, OFT TIMES, AT THE LOCAL LEVEL, COME FROM THE LOCAL BUSINESS COMMUNITY AND THESE SAME BUSINESSMEN AND WOMEN.

AS ANOTHER POINT, WE CAN SEE THE GROWTH OF EXECUTIVE DINING ROOM DINING OR ENTERTAINMENT IN COMPETITION WITH FREE ENTERPRISE OR THE INDEPENDENT RESTAURANT AND TO THE DETRIMENT OF THE INDUSTRY WHICH RECORDED $162.8 BILLION DOLLARS IN SALES NATIONALLY LAST YEAR AND PROVIDED SOME 8 MILLION JOBS TO HELP THE NATIONAL ECONOMY. HERE IN THE STATE OF WASHINGTON, OUR INDUSTRY HAS SOME 2500 FULL SERVICE RESTAURANTS WITH LIQUOR SERVICE; SOME 1800 TAVERNS, MANY OF WHICH HAVE FOOD, SOME 2500 FAST FOOD PLACES AND ANOTHER 1,000 WHICH QUALIFY AS DELIS, VENDING, SCHOOL AND CAMPUS FACILITIES, HEALTH CARE AND COMMUNITY FEEDING CENTERS, INSTITUTIONS SUCH AS PRISONS, MOBILE CATERING AND EVEN GAS STATION AND GROCERY STORE FOOD SERVICE FACILITIES. IN THIS STATE, WITH A POPULATION OF 4,384,100, SOME 1,963,900 HAVE JOBS OR LESS THAN 50 PERCENT OF THE POPULATION. BECAUSE SOME 2,139,900 ARE CONSIDERED PART OF THE LABOR FORCE, WE HAVE AN UNEMPLOYMENT RATE OF 8.2 PERCENT. THE REST OF THE PEOPLE FALL INTO SUCH CATEGORIES AS DISCOURAGED WORKER, STUDENT, SENIOR CITIZEN, CHILDREN, HOUSEWIVES, RETIREES, ETC. THIS REDUCES OUR POTENTIAL CUSTOMER COUNT. WE PROVIDE JOBS FOR SOME 108,000 PEOPLE ON A FULL TIME OR PART TIME BASIS AND DO AN ANNUAL BUSINESS OF SOME $2 BILLION, 500 MILLION DOLLARS. WE HAVE SEEN MANY

NEW PLACES OPEN AND MANY, UNFORTUNATELY, CLOSE. THE CLOSURES WERE DUE TO LACK OF CAPITAL, LACK OF BUSINESS EXPERTISE, COMPETITION AND BAD ADVICE. EXPERTS IN OUR INDUSTRY EXPECT THAT SOME 45% OF TODAY"S RESTAURANTS FACE THE THREAT OF GOING OUT OF BUSINESS IF THE ECONOMY FALTERS. THE NATIONAL AND LOCAL ECONOMY, THE ADVERSE EFFECT OF THE DWI CAMPAIGNS, WHICH HAVE SEEN HARD LIQUOR SALES DROP IN SOME SITUATIONS AS MUCH AS 20 TO 30%, AND CHANGES IN CONSUMER PREFERENCES AS TO FOOD HAVE AFFECTED OVER 25% OF OUR MARKET. THESE CUSTOMERS WANT FRUIT, FIBER, VEGETABLES AND DISDAIN THE ONE TIME AMERICAN FAVORITES OF ROAST BEEF AND MASHED POTATOES AND GRAVY. WE LIVE IN A CALORIE COUNTING, NO-SALT, NO-SUGAR, NO-FAT MENU ERA.

WE ENJOY A FREE ENTERPRISE OR MARKET ATMOSPHERE AND DON'T WANT TO CHANGE IT.

THAT SAME FREE MARKET CREATES COMPETITION WHICH MAKES CONSTANT MENU AND PRICE EVALUATION A TASK FOR THE OPERATOR WHO WOULD BE SUCCESSFUL. RESTRICTIONS ON FOOD ITEMS CONTAINING SULFITES, ADDITIVES, PESTICIDES, SWEETENERS, ANTI-BIOTICS, CAFFEINE, NO SMOKING LAWS, AND OTHER PROHIBITIONS HAVE MADE DAILY OPERATIONS DIFFICULT.

MANY LIQUOR ESTABLISHMENTS FACE EXCESSIVE INSURANCE COSTS TO PROTECT DWI LIABILITY.

LOOKING AGAIN AT THE PRESIDENT'S AND TREASURY PROPOSALS WE EXPRESS CONCERN OVER CHANGES IN FRINGE BENEFITS, TAXING HEALTH PLANS ABOVE A CAP, AND MAKING GROUP TERM LIFE INSURANCE AND LEGAL SERVICES AS TAXABLE ITEMS. ALREADY WE FACE BIG LIQUOR TAX INCREASES IN OCTOBER, ADDED RESTRICTIONS AND RECORD KEEPING OF TRUCK AND AUTO USE BY HOTELS AND RESTAURANTS. THE REMOVAL OF DEDUCTIONS FOR LOCAL TAXES CONCERNS US AS IT AFFECTS OUR LABOR COSTS AND AS IT REDUCES SPENDABLE INCOME.

THE TAXING OF LIFE INSURANCE POLICIES ALSO AFFECTS SPENDABLE INCOME ADVERSELY.

AS WE LOOK AT THE STATE AND NATIONAL ECONOMY, WE HAVE TO SHARE WITH YOU SOME FEAR THAT THE BALANCE OF TRADE DEFICIT, THE HUGE FEDERAL BUDGET DEFICIT, THE 7 TRILLION, 145 BILLION DOLLAR CONSUMER DEBT, GIVE US CAUSE FOR GREAT CONCERN.

ON THE PLUS SIDE, WE LOOK FORWARD TO EXPO '86, THE CANADIAN WORLD'S FAIR NEXT YEAR AND WE HOPE THAT SOME IMMIGRATION AND CUSTOMS PEOPLE CAN BE TRANSFERRED TO ENTRY AND EXIT POINTS TO BRITISH COLUMBIA TO SPEED TOURIST PASSAGES. AGAIN ON THE PLUS SIDE, THE COMPLETION OF THE WASHINGTON STATE TRADE AND CONVENTION CENTER

IN 1988 HOLDS BRIGHT HOPE FOR AN IMPROVING ECONOMY.

BUT IN CONCLUSION - AND TO PUT IT QUITE FRANKLY, THERE IS AN UNEASY FEELING IN MANY QUARTERS ABOUT THE DIRECTION OF THE ECONOMY, AND IT TAKES A NEW INITIATIVE BY BOTH STATE AND FEDERAL GOVERNMENT TO RESTORE CONSUMER CONFIDENCE. SOME OF THESE PROPOSALS BEING DISCUSSED TODAY DO NOT LEND THEMSELVES TO CONFIDENCE IN THE FUTURE. WE DO NOT NEED A TRADE WAR, ANY KIND OF WAR OR EVEN A DEPRESSION TO WAKE US UP AND PUT US ON A NEW TRACK. THE STATISTICS AT HAND GIVE US FAIR WARNING THAT WE MUST DO EVERYTHING POSSIBLE TO KEEP OUR ECONOMY STABLE AND GROWING. THE PROPOSALS WE HAVE REVIEWED IS CALLED A "RECIPE FOR FAIRNESS, GROWTH AND SIMPLICITY." WE AGREE WITH THE PRESIDENT THAT THE PEOPLE WANT CHANGE AND A REDESIGNING OF THE TAX CODE WOULD SEEM TO BE A STEP IN THE RIGHT DIRECTION, BUT WE HAVE FOUND SOME SINKHOLES IN THAT DESIGN THAT NEED CONGRESSIONAL RE-EVALUATION SO THAT IN MOVING THIS COUNTRY TO A NEW HORIZON, WE HAVE NOT INADVERTENTLY SET UP CHAOS FOR ONE SEGMENT OF THE ECONOMY AS A SUBSTITUTE FOR PROGRESS. I THANK YOU.

Senator GORTON. Thank you, Jack.

Mr. DuJardin.

STATEMENT OF DAVE DUJARDIN, DUJARDIN DEVELOPMENT, EVERETT, WA

Mr. DUJARDIN. It is nice to be here today and to see you again. We have supported the President and this administration since 1981 and watched our subsidized housing starts drop, new starts, by 50 percent in that period of time. But they were replaced in 1981 by three tools that this administration gave us: Syndication, revenue bonds, and block grant funds for the cities for housing and community development. We have used these tools since then, but it takes us a couple of years to probably get the thing working and get bond counsel to say that you can issue those revenue bonds and get a State finance agency formulated, and we were a little slow locally on that.

However, I am concerned about our State. I don't think you are going to be able to get a continued recovery, modest recovery, in this country without a strong automobile industry, without a strong housing industry, and without consumer confidence in spending. That has been a little evasive to know just how that all comes together when that individual makes up his mind how he is going to spend his dollars, but it does have something to do with the amount of down payment he has to make and how much the monthly payment is.

So, I kind of view whatever you do to the community as kind of what you do to housing, because we do provide a place, a shelter, for these people. I also manage a couple thousand units that we have built, and about half of those are elderly. We don't have any new programs, and the Farmers Home Program is being cut back 50 percent. We have been using the industrial revenue bonds to provide lower rents. We have an issue that just came out from our

National Association of Home Builders that pretty well spells out the industry's position of the effect on raising rents by 28 to 40 percent before we can build another unit. So, we are predicting the start of the next housing recession January 1, 1986. Assuming adoption of the President's tax proposal.

Our State hasn't recovered, really, most of it. Now, Seattle has done well since 1983 or 1984 and this year looks like a good year. But I have a dairy over in Lewis County and orchard over in Yakima, and those areas are really sad. They are the pits. These guys just have it difficult to make a living in building or any other kind of industry over there. I also serve as a founding director of a local bank, so I see some different aspects and we argue internally of what these effects will be.

I think in the construction industry, with these reductions, it is going to affect rental housing the most, a severe drop immediately. We are building using the industrial revenue bonds. Without that and without the ability to attract the capital required for the downpayment on the rental units, these are all cranked into the rents.

So, as soon as we can raise those rents 25 to 40 percent, then you can take the heat for rent control. It hasn't been around for a while, and it didn't work too well in New York, but it might be a national issue if we raise rents to that 60-cent level or 70 cents per square foot that maybe you are used to on the east coast but our people out here really resist that kind of a rent level. We will have to have it before we can build the next unit if we don't have industrial revenue bonds or the syndication.

What that will cause is doubling up. Your kids aren't going to be able to leave home. Once they leave home, they are going to come back and live with you, and we don't look forward to that as a good American way of living. I don't see where their choice is going to be, and we are giving them our deficits and our imbalanced payments to go with that.

I am really looking forward to getting your Technical Corrections Act through. There are 225 pages that came out in the 1984 Technical Corrections Act effective July 1, 1984, that I really haven't digested, but I think it really might help me get to my defined benefit trust so that I can support myself in a different way than trying to build units that people aren't going to be able to afford at the higher interest rates.

I see a more modest effect on the single-family construction. About 25 percent of our work is in that area. We build about 400 units a year, 300 rentals and 100 single families. It is going to cost them more in their after-tax dollars for their monthly housing, because they are not going to have as big a deduction for their local taxes and their local taxes will not be a deduction under this proposal. So, they are going to be able to afford less in monthly payment. Once we can get them qualified, then they have to be willing to buy that more modest commodity that we can offer.

We in this State are really in a very vulnerable position, I think, as far as economic recovery. If you stay in Seattle, it isn't so bad, but don't go to Watcom County, Skagit County, Lewis County, and expect people to worry about their income tax. They just don't have a taxable problem.

I guess the caution I would make as we go back and do our technical reviews—and now we are going to have a whole brandnew one and we haven't got the technical review of 1984 done yet—I would like to cite applicable rule 58, section (h). It is only 3½ lines and it applies to the alternative minimum tax. That was really my answer to the last question you asked these people. Let's broaden the alternative minimum tax and make more people pay at least a minimum tax. I think it is fair, more equitable, if we have to have the present tax system. And it is not fair, it is not equitable, and it is not simple. My personal and corporate tax are three-quarters of an inch thick.

But when you abrogate your power to the Treasury Department under 58(h), regulations to include tax benefit rule, and you say,

> The Secretary shall prescribe regulations under which items of tax preference shall be properly adjusted for their tax treatment giving rise to such items will not result in the reduction of the taxpayer's tax under this subtitle for any taxable year.

That is just confusing to all tax attorneys, to all the accountants, to me as a businessman trying to know what the alternative minimum tax does to me.

The way it really works out on our side, the Treasury is our intimate enemy. They want our cash-flow, as one of these guys mentioned, and we want to hang onto it as long as possible. So, the Treasury then delays coming out with these regulations sometimes 5 years. Then they get a good test case, create some tax code by the courts, and then they go back retroactively 3 years and enforce that very clear, concise law that they have created.

And you meant to do it, right? I am not so sure sometimes that the intent of Congress is really expressed through the Treasury who is a monkey counting bananas.

I thank you for listening.

Senator GORTON. Thank you.

Mr. Christianson.

STATEMENT OF KEN CHRISTIANSON, PRESIDENT, ALF. CHRISTIANSON SEED CO., MOUNT VERNON, WA

Mr. CHRISTIANSON. Thank you. My name is Ken Christianson. I am the President of Alf. Christianson Seed Co. in Mount Vernon, WA. We are vegetable seed growers in the business established by my grandfather in 1926.

Approximately 70 percent of our trade is in export sales. Accordingly, we are intensely interested in foreign exchange rates and in the balance of trade.

In this morning's P.I., there is reference to a record merchandise trade deficit for the second quarter of 1985, $33.4 billion, following the prior record for the third quarter of 1984 which was $32.5 billion. In the article, there is reference made by the U.S. Trade Representative, Clayton Yeuter, whose statement is, "The Reagan administration hasn't moved to solve the trade crisis."

I realize we are here today to speak on the impact of the tax reform proposal, but also I think if we come around the other side of the circle, one of our great concerns must be this trade imbalance which we have which, in many cases, maybe leads us to the necessity for tax reform.

Senator Gorton, I appreciate the opportunity to speak here at your hearing today.

We are very closely related to agriculture in the vegetable seed production, and this is the season of our harvest. Today, my company is working 24 hours a day in the midst of one of the largest harvests we have had in recent years. As a consequence, I have limited time to devote in great detail to the many issues which were addressed in the mail receipts from your office, but I would like to briefly address each issue.

One of the questions we have, one of the concerns we have is the issue of indexing and what we as small businesses might expect from indexing. We realize it has been utilized in the past, but it has more of a focus today in the taxing issues. What should we expect from indexing wherever it is utilized, and is there any standard or historical comparatives which we should expect from indexing?

The relative domestic value of the U.S. dollar today compared to what it was even a few years ago is frightening. For our company, it has vast impact. This issue we are most concerned about.

The issue of corporate dividends, we would like the Treasury to revert to at least a 50-percent deduction. Maximum relief should be sought from the inequity of double taxation.

Concerning the investment tax credit, as has been mentioned several times here this afternoon, we would like to see reinstatement to cover the required assets of specific businesses. This asset base which is so vital to American industry I think we must be concerned about and we must give small business the opportunity to build their asset base so that they may compete with larger industry as well as competition from abroad.

Depreciation is an issue which is a bit difficult for us to assess, but we believe CCRS is comparable to the current law.

We support the current law for expensing capital assets.

We also express support for the current law for interest expense deductions.

On inventories, we think the measuring of capabilities of indexing is uncertain here again, and we would like to see that none of the allowable benefits of the LIFO should be reduced.

We believe that industrial development bonds should have similar tax deductible merit as other State or local issues.

Concerning international provisions, we have had a domestic international sales corporation for many years. It has been very good for our corporation. We have recently developed a FSC corporation. Considering the tremendous disparity between foreign currencies and the U.S. dollar and the vital need for improvement in the international balance of trade, there should be no question, we believe, of reducing any benefits which may be enacted by the foreign sales corporation taxing structure.

We do not expect to realize greater benefit from the FSC corporation, but still we feel it is vital for us to have this. We sell our vegetable seeds all over the world. Our largest market probably is Japan, but also we sell considerable volumes in Europe. In Europe, every pound of seed that we ship there has a 10-percent duty put on it before it comes into the market. So, we not only have the great problem of the balance of trade which, since 1981, has caused us great concern, but we also have this imposition on our seeds going into foreign markets.

So, this added help from either a DSC or a FSC corporation is of vital interest to us as small business.

Concerning fringe benefits, we think probably there is room for some reform there, but the basic benefits of medical insurance and life insurance provided by employers should not be considered an appropriate field for taxation, we feel. The issue was raised in a publication from your office that many businessmen argue that this is something valuable, to draw talented employees to their employ, but my personal feeling is that the benefit from corporate medical or insurance programs, I think, is a great benefit to the blue collar worker, the man who maybe makes, say, $15,000 to $20,000 a year. That is a pretty valuable benefit to them. If they are the ones who are taxed on this benefit, I think it is going to be pretty significant to them and their families.

Other fringe benefits, perhaps, which are mentioned maybe could more likely be taxed. But the basics of the medical insurance and the life insurance and possibly salary continuation programs, I think, should be absent from taxation.

In summary, while the ways and means and relative trade-offs are of considerable importance in the levying or raising of taxes, of certain concern to you should be the budgeting of the dollar demands on the taxpayer.

A theory of total accountability should be required of all elected representatives. Each should be required to report, on a month-to-month basis, on their personal efforts toward the reduction of the national deficit. The personal accountability should be emphasized, and accomplishments toward the elimination or reduction of pork barrel projects, the reduction of departmental expenditures against budget, and the reduction of bureaucracy manning scales and salary structures, the elimination and/or reduction of departmental redundancies, and elimination of congressional perquisites.

In the final analysis, our representatives should be measured by their contribution to economic stability.

We recognize the need for taxation in our own company. We do want to make our contribution to the needs of Government, but there is a great inequity in our Government's spending more than is there. Now, we are in a catch-up mode, and I hope that people in Congress will have the courage to do what is necessary, and I hope that what is necessary doesn't solely fall on the shoulders of the taxpayer.

Again, I thank you, Senator. We do appreciate the opportunity to testify.

[The prepared statement of Mr. Christianson follows:]

Alf. Christianson Seed Co.

60 YEARS A GROWER OF
QUALITY VEGETABLE SEED
FOR THE WHOLESALE TRADE
MEMBER OF A.S.T.A. S.S.A.
P.S.A. AND W-N.I.S.A.

PHONE 206/336-9833
TELEX 32-1224
CABLE CHRISEED
BANK SEATTLE FIRST NAT'L
MOUNT VERNON BRANCH

P. O. Box 98, Mount Vernon, Washington U. S. A. 98273

August 19, 1985

My name is Kenneth George Christianson. I am president of Alf. Christianson Seed Co. with headquarters in Mount Vernon, Washington. We are vegetable seed growers in the business established by my grandfather some sixty years ago.

Approximately seventy percent of our business is in export sales, accordingly we are intensely interested in foreign exchange rates and in balance of trade.

By far the greater part of the rest of our business is in interstate sales.

In this morning's P.I., August 19, 1985, there is reference to a record merchandise trade deficit for the second quarter of 1985 33.42 Billion following the prior record for the third quarter of 1984 32.51 Billion in the article is reference to U.S. Trade Representative CLAYTON YEUTTER statement to the effect

> "Reagan administration hasn't moved to solve the trade crisis."

In lieu of all other warranties, expressed or implied (including any implied warranty of merchantability or fitness for a particular purpose), and all other obligations or liabilities, we warrant to the extent of the purchase price that the seeds we sell are as described by us on our container within recognized tolerances. Our liability whether contractual, for negligence or otherwise, is limited in amount to the purchase price of the seeds under all circumstances and regardless of the nature, cause or extent of the loss, and as a condition to any liability on our part, we must receive notice by registered mail of any claim that the seed is defective within 30 days after the defect in the seed becomes apparent. Seeds not accepted under these terms and conditions must be returned at once in original unopened containers and the purchase price will be refunded.

Alf. Christianson Seed Co.

90 YEARS A GROWER OF
QUALITY VEGETABLE SEED
FOR THE WHOLESALE TRADE
MEMBER OF A/S.T.A. S.S.A.
P.S.A. AND [illegible] I.S.A.

PHONE [illegible]
TELEX [illegible]
CABLE CHRISEED
BANK SEATTLE FIRST NAT'L
MOUNT VERNON BRANCH

P. O. Box 98, Mount Vernon, Washington U. S. A. 98273

August 15, 1985

The Honorable United States Senator Slade Gorton

Committee on Small Business
Hearing August 19, 1985
Jackson Federal Building, Seattle, WA

Dear Senator:

Thank you for the opportunity of participating in your hearing. I appreciate.

This is the season of harvest, my company is in the midst of its heaviest receipts of the products of the good earth - vegetable seeds. Our Mount Vernon, Washington Seed Conditioning Plant is working round the clock to assure our contribution to future table vegetable needs.

As a consequence, time constraints has limited my detailed attention to the subject at hand. My contribution may be limited, my interest is without limitation.

One of my questions may be:

> "what might we expect from indexing, wherever it may be utilized, are there authorized historical comparatives?

The relative domestic value of the U.S. dollar today compared to that of even more recent years is frightening.

Corporate Dividends

> Treasury should revert to at least 50% deduction, maximum relief should be sought from the inequity of double Taxation.

Investment Tax Credit

> Should be reinstated or maintained to cover all required assets specifically identified as contributing to the well being of the United States.

Depreciation

> Difficult to assess, however indications CCRS comparable to current law (ACRS).

Expensing Capital Assets

> Support current law with added provision for indexing prior to future limit adjustments.

In lieu of all other warranties, expressed or implied (including any implied warranty of merchantability or fitness for a particular purpose) [illegible] to the extent of the purchase price that the seeds we sell are as described by us on our container within recognized tolerances. [illegible] is limited in amount to the purchase price of the seeds under all circumstances and regardless of the nature, cause or extent of the loss, and as a condition [illegible] must receive notice by registered mail of any claim that the seed is defective within 30 days after the defect in the seed becomes apparent. Seeds not accepted [illegible] in original unopened containers and the purchase price will be refunded.

Interest Expense Deduction

Support current law.

Inventories

The measuring capabilities of indexing is uncertain; none of the allowable benefits of LIFO should be reduced.

Industrial Development Bonds

Interest on IDB's should have similar deductible merit as other state or local government issues.

International Provisions

Considering the tremendous disparity between foreign currencies and the U.S. dollar and the vital need for improvement in the international balance of trade, there should be no question of reducing or minimizing any benefits which may have been enacted in Foreign Sales Corporation taxing structures.

Fringe Benefits

Basic benefits of medical insurance and life insurance provided by an employer should not be considered an appropriate field for taxation. Certainly relieving the first $5,000.00 of employer provided death benefits should be considered the minimum of taxation relief under such circumstances, out of respect for the departed and in consideration of survivors.
Tax free treatment of the first $5,000.00 of employer provided death benefits should at least be retained.

In summary - while Ways & Means and relative trade-offs are of considerable importance in the levying or raising of taxes, paramount is the budgeting dollar demands on the taxpayer.

A theory of total accountability should be required of all elected representatives. Each should be required to report on a month to month basis of their personal efforts toward reduction of the national deficit.

Personal accountability should be emphasized, accomplishments toward elimination or reduction of pork barrel projects, reduction of departmental expenditures against budget, reduction of bureaucracy manning scales and salary structures, elimination and/or reduction of departmental redundancies, and elimination of Congressional perquisites.

In the final analysis, our representatives should be measured by their contribution to economic stability.

Thank you Senator and Committee for the opportunity of participation and for my (limited) expression.

Sincerely,

ALF. CHRISTIANSON SEED CO.

Ken Christianson

Kenneth G. Christianson
President

KGC:jm

Senator GORTON. Thank you, Mr. Christianson.
Mr. Crissey.

STATEMENT OF STEN CRISSEY, PRESIDENT, CRISSEY FLOWERS & GIFTS, SEATTLE, WA

Mr. CRISSEY. Thank you very much.

Thank you for your kind invitation to participate as an official witness in your exploration of the impact of tax reform proposals on small business. Your willingness to involve individuals from the small business community in the hearing process is most gratifying.

My name is Sten Crissey. I am president of Crissey Flowers & Gifts, a small, family-owned business and one of over 36,000 retail florists in the country. Crissey's is an S corporation and shares the tax concerns of small retailers whose major investment lies in labor and inventories.

It is generally recognized that existing tax law has been pushed and pulled by so many special interest groups that significant tax reform is long overdue. The standards of equity, neutrality, and simplicity have been compromised beyond the point of tolerance.

Recognition of this fact has provided the impetus for the three alternative proposals we are reviewing today, the Treasury Department proposal, the Kemp-Kasten proposal, and the Bradley-Gephardt proposal. I understand that in the review process, the committee desires to weigh current tax law against these various reform proposals and to evaluate each against the standards of equity, neutrality, and simplicity. Accordingly, I will address each standard separately and first try to demonstrate by example how the various proposals succeed or fail. At the same time, I will endeavor to show why the Treasury Department recommendations seem most successful in addressing the three Tax Code standards as they relate to small business.

The first standard to consider is equity, or taxing the same incomes equally. The Treasury Department proposal effectively attacks this issue through the elimination of many deductions such as bad debt reserve, entertainment expense, and business meals and travel expense excesses. Unquestionably, loss of bad debt reserve deductions will have an adverse impact on businesses such as ours who depend heavily on credit. Other businesses will be hurt by the loss of other deductions. The key, though, in equity is whether similar incomes receive similar treatment, and I think they do under the Treasury Department proposal, if the plan is revenue neutral as it claims to be.

Another move toward equity in the Treasury Department plan provides for indexing FIFO inventories in order to more accurately reflect inflation factors. Similar indexing provisions will be extended to those who invest in depreciable assets and capital assets. Accordingly, a greater level of equity is achieved. Neither the Kemp-Kasten nor the Bradley-Gephardt proposals provide for indexed FIFO and thereby place small retailers on an unequal footing with businesses that can index part of their assets.

A failing in all proposals results from assessing one tax rate on income for individuals and another tax rate for corporations when each has reached the same taxable income level. For example, under the Treasury Department plan, when an S corporation shareholder has taxable income between $29,000 and $50,000, he will pay 7 percent higher taxes than a firm paying at corporate rates.

In the Kemp-Kasten proposal, the shareholder would pay 5 percent higher rates on taxable income from $3,500 to $50,000. Bradley-Gephardt reverses the inequity by assessing corporations at 30 percent while S corporation shareholders would not be subjected to such rates until they reach $65,000. This would undoubtedly encourage many small corporations to become S corporations. In any case, inequity exists with all three proposals though least with the Treasury Department's plan.

Regarding neutrality, or the respective tax treatment of businesses in various industries, the Treasury Department proposal has significant improvements over current law. Indexing inventories for inflation as well as indexing the residual values on depreciated assets helps to establish parity between industries. As a result, small retailers, service businesses, and firms with heavy investments in depreciable assets are all able to stand on neutral tax ground. As previously mentioned, neither Bradley-Gephardt nor Kemp-Kasten provide for indexing of inventories.

Additional neutrality is achieved by widening the tax brackets as is recommended by all three proposals. Almost by definition, this will cause more industries with similar taxable incomes to pay at the same rates. As already noted, however, the Bradley-Gephardt and Kemp-Kasten plans tend to create inequities between corporations and individuals.

Another step toward neutrality would come from eliminating investment tax credits as all three alternative proposals request, thus taking away an advantage given to businesses with heavy investments in depreciable assets. Whereas this measure would be acceptable for the retail segment of the floral industry in a revenue neutral environment, it would have a severe negative impact on the growing segment of our industry which relies heavily on investment tax credits on greenhouses to finance expansion. Submitted with my written testimony is a more detailed explanation of growers 'concerns in this regard.

Finally, tax simplicity. Generally, the Treasury Department proposal fares well. Broadening tax brackets, eliminating investment tax credits, and reducing acceptable deductions all serve to simplify.

Capital gains, which is inherently complex, is simplified in the Treasury Department plan by the elimination of depreciable property from consideration. Bradley-Gephardt simplifies capital gains most by treating it as earned income. Whereas this makes it simple, it does not seem realistic. The options provided under Kemp-Kasten complicate capital gains even more than exist under current law.

The most notable failure of the Treasury Department plan regards depreciation. If the Federal Government is serious in its efforts to accommodate "the many small businesses who cannot afford the tax expertise necessary to comfortably comply with our current tax laws," as has been suggested in the information sent us by the Senate Committee on Small Business, then they should know they have failed on the issue of depreciation. It is hard to imagine many small business operators calculating depreciation in accordance with Treasury Department proposed requirements without assistance from professional tax experts.

To establish equity, neutrality, and simplicity in the American Tax Code is admittedly a most difficult undertaking. However, in the long run, the effort will result in a stronger, healthier small business community which will mean more jobs, a stronger economy, and a better vehicle with which to address the problems of the deficit. I laud your efforts and encourage you to persevere.

Thank you.

[The prepared statement of Mr. Crissey follows:]

STATEMENT
OF
STEN CRISSEY
AT THE UNITED STATES SENATE COMMITTEE ON SMALL BUSINESS
SEATTLE HEARINGS
ON
TAX REFORM

AUGUST 19, 1985

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Thank you.

ADDENDUM

The floriculture industry has three distinct segments which complement and in some cases compete with each other. These segments are composed of retail florists, wholesalers who not only act as middlemen for floral product but also provide the industry with pots, soil, moss, and many other products, and the third segment, growers.

Growers, who provide the product for the floral industry may view some aspects of tax reform differently than the average florist. In particular, growers have expressed misgivings about the possible loss of the investment tax credit and the loss of cash accounting procedures. The hardships imposed on growers by these two provisions of tax reform, I am told, would not be offset by lower overall tax rates.

Growers have been particularly hard hit in recent years by a myriad of problems, including higher labor and energy costs, a rising minimum wage, dramatic increases in payroll taxes and environmental controls by the Environmental Protection Agency (EPA) which have severely restricted pesticide availability. Technological advances require heavy capital investment to make the industry competitive with foreign growers which often have the advantage of more favorable climates, lower labor costs, subsidies, and less restrictive pesticide laws.

INVESTMENT TAX CREDIT

Our industry's growers have used the investment tax credit the way Congress intended it to be used, expanding operations, becoming more competitive through construction of energy saving structures, and increasing production. This has resulted in an increase also in the number of jobs created.

A greenhouse constitutes an essential and integral part of producing flowers and plants. Without its uniquely designed controlled environment, many flowers and plants could not be produced in adequate quantity or quality. The greenhouse, because of its translucent construction and the environmental watering, fertilizing, insect and disease control equipment is a uniquely designed structure.

The use of the investment tax credit provides a badly needed stimulus to numerous small growing operations to add greenhouse space and to expand.

CASH ACCOUNTING

The floral and nursery industry have for sixty years been excepted from the requirements of accrual based accounting for sound practical reasons. It is virtually impossible for a grower to assign a value to a crop at any given stage of production, which would be a valid measure of the crops worth at a later stage. For instance, a poinsettias is worth much more at maturity than as a cutting, and a mature poinsettia is worth more in early December than it is in late December.

How would a grower determine the value of a crop which has not reached maturity and saleability. Since they would have to be inventoried at an incomplete stage, they may not reach maturity and/or saleability at all. Even if you could establish a price at inventory time, how will credits for lost crops be handled? There is nothing more uncertain than the value of a florist's crop until it is sold.

The impossibility of proper valuation was recognized by the Internal Revenue Service over 60 years ago. There are no new accounting concepts to change the original conclusion. And the same physical factors--insects, disease, inclement weather, market demands and pressures, and numerous other unforeseeable factors--continue to plague the industry today.

Floriculture growers produce a great variety of crops each of which have different production, biological and market problems. These factors would make taking inventory, even if possible, prohibitively expensive for the small businesses involved. One firm has estimated the costs for conducting such an inventory to be $20,000.

In addition, most of the floral grower operations are family businesses which have been handed down through generations and are not the subject of tax sheltering investments. This has been recognized by Congress repeatedly.

In conclusion, for the members of the floricultural industry, crop inventorying would create an administrative nightmare and would generate little in increased revenue for the IRS. It is impossible to place a value on floral crops because, the market cannot be predicted, crop losses can occur at any time due to adverse weather, disease, over watering, etc., a plant has no value until it is sold. Few growers are sophisticated enough to cost out plants at various stages of growth. If forced to crop inventory the grower will have to pay taxes on a paper profit. This will not achieve the President's goal of matching income with costs of doing business and it certainly is not "simplicity."

Senator GORTON. Thank you.

All of you sat here, I believe, through the preceding panel, so you have had a chance to think about your answer to the next question. You are going to get the same one. I am just going to start with you, Sten, and go across and ask the question.

If you had to take the President's tax reform proposal without any change at all or continue with the present tax system without any change at all, which choice would you make?

Mr. CRISSEY. I would definitely take the President's tax proposal. It seems to me that it adequately and fairly, across the board, addresses the concerns of neutrality, equity, and simplicity.

Senator GORTON. Mr. Christianson.

Mr. CHRISTIANSON. We would opt for the President's proposal as well.

Mr. DUJARDIN. I think that is an unfair alternative, because we are presented with a set of guidelines and you sitting there with all of this input and Rostenkowski has been out there gathering all this input, and this is the American way is to have a debate. I think give and take should be a part of it.

Personally, I would take the President's proposal. As being in the industry and in the building business, I would have to say we can't swallow it one more time. We are out of business. We are done. You have brought us to our knees. Take the blood. We are done anyway. It doesn't matter. So, I would have to stay with present law.

Senator GORTON. With present law?

Mr. DUJARDIN. Exactly, because it is terrible, it is unfair, it is inequitable, but it is the law, and you have enough trouble with that.

Senator GORTON. Jack.

Mr. GORDON. Reluctantly, I would have to go with the way it is because of the reservations we have indicated.

Senator GORTON. All right. Now, all four members of the preceding panel, agreed that if they could only get one change in the President's proposal, they would retain in whole or in part the investment tax credit. I am sure that will not be the answer across here, but I would like to ask you that question. If you could just make one change in the President's proposal from the perspective of small business, what would it be?

Mr. CRISSEY. In deference to the grower segment of our industry and the lifeline that they provide to the retail segment, and knowing the impact of the investment tax credit on that segment of our industry, I think I would opt for a way to retain the investment tax credit.

Senator GORTON. That is a particularly impressive answer, because it doesn't do much good for your own personal business, does it?

Mr. CRISSEY. No.

Senator GORTON. OK. Mr. Christianson.

Mr. CHRISTIANSON. The way I view it, for business, it is the net tax one would pay. Now, the investment tax credit is important to us as well, but the issue of the 33-percent tax applied to the $77,000 level and to where it would eliminate the indexing below that level, the gentleman on the previous panel who said if that level were raised to a more practical or reasonable level such as $200,000, for us, I think, for our firm as small business, that would be a meaningful change. Then, for instance, if we lost the investment tax credit or it was reduced, if this level of taxation at 33 percent were raised significantly but within reason—I don't think $75,000 is reasonable, but if it were $200,000——

Senator GORTON. Approximately $200,000.

Mr. CHRISTIANSON. Yes. Then, that would offset some of the sting of the investment tax credit.

Senator GORTON. Dave, this gives you at least a little shot at it now. What change would you make?

Mr. DUJARDIN. All I want for Christmas? I guess I would keep the industrial revenue bonds with a safe haven as they are for States or multifamily housing. It gives us a chance to provide some new construction. The other tools are all gone.

Senator GORTON. Jack, I think I know what your answer is going to be, but we want it on the record.

Mr. GORDON. Well, I would agree with Mr. Christianson, I think. Raising it would be the best.

Senator GORTON. That would be more important than the entertainment and meal provisions?

Mr. GORDON. Well, that is pretty loaded, isn't it? I didn't understand your hooking that on.

Senator GORTON. No, no. I am saying you are going to get one change from the President's proposal.

Mr. GORDON. Oh. Well, we have several.

Senator GORTON. I know. The most important, though.

Mr. GORDON. I think probably the credit thing would be probably more if we got down to that in view of the fact that relatively small numbers of restaurants and a large number of hotels would be involved. But looking at the situation from everybody's point of view, not just those who are directly affected, I would agree with Mr. Christianson but somewhat reluctantly.

Senator GORTON. OK. Obviously, these are, in a sense, artificial questions. Dave is right about that. The political process is one of judgments and of making changes. It is quite safe to say that the final choice is not likely to be nothing at all or the President's proposal without any changes whatsoever.

From our perspective, because we have to vote, it is very important for us, particularly when we will get six or eight or three dozen critiques of it, to know what some of the most important are and some of the least important. Staff here tells me, for example, that our hearings here in the State of Washington have had a far greater emphasis on the importance of the investment tax credit than have similar hearings in other places in the country. That may not mean that there is so much difference here in the State but simply that people have had a longer time to think about that question as they have looked it over.

However, it is important because, in the Senate at least, it will be many months before we are actually debating this proposal. The changes that anything eventually will be passed are highly questionable, I think not more than 50/50. So, for me, the 2 days of hearings we have had have been very important and very enlightening. You all have made a major contribution to them, and I thank you for that.

We are adjourned.

[Whereupon, at 4 p.m., the committee recessed, to reconvene subject to the call of the Chair.]

IMPACT OF TAX REFORM AND SIMPLIFICATION PROPOSALS ON SMALL BUSINESS

AUGUST 27, 1985

U.S. SENATE,
COMMITTEE ON SMALL BUSINESS,
Fort Smith, AR.

The committee met, pursuant to notice, at 10 a.m., in the Gardner Building Lecture Hall at Westark Community College, Fort Smith, AR, Hon. Dale Bumpers (acting chairman of the committee) presiding.

Present: Senator Bumpers.

Staff present: John W. Ball III, minority chief counsel; and Charles E. Ludlam, minority tax counsel.

STATEMENT OF HON. DALE BUMPERS, A U.S. SENATOR FROM THE STATE OF ARKANSAS, AND ACTING CHAIRMAN, COMMITTEE ON SMALL BUSINESS

Senator **BUMPERS**. The committee will come to order. I start by apologizing for the delay in getting started this morning. I like to be very prompt, but we had a little difficulty in getting up here this morning on the plane, so I apologize to all of you for having kept you waiting.

Before I say anything else, let me say one thing. I made a speech the other night, and, just on the spur of the moment, I made a reference to the fact that when I was 15 years old my father had the hardware and furniture store and funeral home in Charleston. Back in those days if you had a hardware store, you also ran the funeral home. I think the hardware stores used to build the caskets.

In any event, one time my father, after school, asked me to go with him to pick up a man who lived just across into Sebastian County from Charleston and to take him to the Sebastian County Poor Farm. This was during the height of the Great Depression. So I went out there with him, and we went into this house that only had half a roof and chickens scratching around in the fireplace. This old man had nobody to take care of him and was lying in bed in an unbelievable situation. We put him in what was either an ambulance or a hearse, depending on what you were using it for, and brought him to the Sebastian County Poor Farm. The Sebastian County Poor Farm was located where we are seated at this very moment.

A lot of people remember that. I can't help but think what tremendous strides we've made in this country since then. Now every time I come to Westark Community College, I think about that story because it made such an indelible impression on me.

Because of my concern for Westark and belief that it was such a fine institution—and Sandy Sanders, you certainly will remember this—I sponsored the community college bill when I was Governor, and now the Community College Program in the State is one of the things I take the most pride in. Certainly this is still the flagship of the community colleges in Arkansas. So it's good to be with you and especially good to be here.

Let me begin this morning by welcoming all of our distinguished witnesses and thanking you for taking valuable time away from your busy schedules to be with us.

I know for small business people, time is money, and I can assure you that your remarks and comments here today will lay a firm foundation from which the Senate Small Business Committee can speak on behalf of small businesses in the current debate on tax reform.

Small businesses constitute the bulk of business establishments in Arkansas. Out of 42,000 businesses in Arkansas, 24,000 have 4 or fewer employees. Nearly 200,000 employees work in these small businesses in this State.

More specifically, in Sebastian and Crawford Counties 1,582 of the 3,039 business establishments have 4 or fewer employees, and 2,612 have fewer than 19 employees.

There may well be no issue in the tax bill that's more important than the impact it's going to have on these small businesses. If the tax reform bill does not help small businesses, then it cannot constitute reform.

This hearing is a part of a series of hearings on the impact of tax reform on small business. Previously the Small Business Committee has held hearings for 11 days on this issue in seven States. All these hearings are being published by the committee and will be forwarded to the Finance Committee with recommendations.

There is perhaps no legislative issue pending before the Senate which potentially affects more people in this country than tax reform. Everything we do as individuals or workers has tax consequences, and most people are at least aware of the tax angle when they make economic decisions. In fact, one of the key issues in this current debate is whether too many decisions are made based on tax incentives or disincentives rather than on pure economic grounds. I think today's witnesses will find that they have much in common in their views on tax reform. There's a part of the pending tax reform proposal that affects every type of business. One's view of tax reform depends on one's current sources of income, the type of expenses one incurs, and the degree to which one relies on various tax preferences.

For many small businesses, the proposed reduction in the tax rates will more than offset the loss of tax deductions and credits. For others the loss of even one current tax deduction might make the crucial difference between being competitive and being insolvent.

That's what the committee needs to know more about as we review the tax reform proposals over the coming months. The Finance Committee has held many days of hearings on tax reform in

Washington. At these hearings major small business groups have testified generally in favor of the present tax reform proposals, particularly the lowering of the rates, the reduction in capital gains rate, and the retention of progressive tax rates.

John Motley, of the National Federation of Independent Businesses, which is by far the biggest small business organization in the United States, has said that the present proposal is preferable to the current Tax Code. At the same time, these groups have expressed concern about the repeal of the investment tax credit, the restrictions on the use of the cash method of accounting, and the possible taxation of fringe benefits.

I'm here to find out, on behalf of the Small Business Committee, what small business men and women in western Arkansas think about these issues. Of course, everyone would like to see lower tax rates, and at the same time retain all the current tax deductions and credits. But with Government deficits of over $200 billion a year, we can't afford a tax cut. In fact, one of the most important questions about the President's proposal is whether it would aggravate the deficit problem. The Joint Taxation Committee has found that the President's proposal would lose the $25 billion in revenues over the next 5 years.

It is tempting for each us to think more about what tax deductions and credits we're losing in tax reform. It's important, however, that we focus on the bottom line. We can't obviously have lower tax rates unless we restrict or eliminate at least some of the tax preferences.

One central feature of the President's proposal is that it substantially raises business taxes to pay for substantial tax cuts on the individual side. Under the present proposal business taxes will rise by $122 billion over the next 5 years, while individual taxes will drop by a $147 billion. I'm interested in your views on whether this shift in the tax burden makes economic sense. It should be noted that business tax accounted for 17 percent of all Federal revenues in 1970 and now it accounts for only 6.2 percent.

We have many witnesses to testify here today. I'm going to ask each of you, if you will, to limit your oral statements to about 5 minutes. If you have a longer written statement, I'll make certain that it's put in the record and included in the hearing record in Washington.

After each member of the panel has spoken, I will have a few questions.

Again, my sincere gratitude to all of you who have come today to this hearing to express your opinions.

Our first witness today is Maurice Lewis, who is head of the Arkansas Hospitality Association. This association is an umbrella group for the Arkansas Restaurant Association, the Arkansas Hotel Association, and the Arkansas Travel Council. The three associations represent 2,500 businesses. Maurice has headed this association for 12 years, and he is also chairman of the State Public Health Advisory Board. Maurice Lewis.

STATEMENT OF MAURICE LEWIS, ARKANSAS HOSPITALITY ASSOCIATION

Mr. LEWIS. Thank you, Senator. Before I begin, on behalf of the Arkansas Hospitality Association I would like to again express our appreciation for the outstanding efforts you have put forth regarding the fish hatcheries in this State. It made a tremendous difference.

Senator BUMPERS. Thank you.

Mr. LEWIS. Senator Bumpers, ladies and gentlemen, my name is Maurice Lewis. I'm the chief executive officer of the Arkansas Hospitality Association. We thank you for the opportunity of being here and for conducting these hearings.

The tax reform proposal submitted by the administration's Treasury Department calls for limiting the deduction for business marketing meals to $25 per person per meal, and only half of the amount spent in excess of this $25 cap. The $25 limit includes the meal, and the tax, and tip. This type of legislative initiative is not an original one. Others have found the so-called three martini lunch to be an easy target to generate press coverage and public support. That label is a misnomer and grossly misrepresents a legitimate business expense that has throughout the years fostered economic growth and employment.

I must add that in this day and age of highly competitive business activity, a literal three-martini lunch would be fatal for a business that wanted to maintain its competitive edge.

Mr. Chairman, I would like to limit my spoken remarks to two areas, economics and public policy. I've gone into very much written detail in the written testimony which I have submitted for reference.

The National Restaurant Association Commission commissioned Chase Econometrics, a leading economic consultant organization, to investigate the full effect on the U.S. economy of the current proposal with and without the business meal provision. This Chase macroeconomic analysis is based in part on a study done for the Treasury Department, Office of Tax Analysis, and in part on other existing research.

In every instance in which the research indicated a range of possible economic effects, the Chase study adopted the more conservative numbers for estimating the economic impact on the restaurant industry and the U.S. economy.

The Chase Econometric study found that in the first year of the limit, 144,000 food service industry jobs would be lost. Federal, State, and local treasuries would suffer a net loss of $1.6 billion due to loss of personnel and Social Security tax revenues coupled with a higher unemployment and welfare expenditures. This loss grows to $6 billion by the end of 3 years.

Restaurant sales would be reduced by $3.5 billion annually. The job losses would severely affect food service employees. By way of background, it should be noted that our industry is one of the largest employers of teens, women, and minorities. We employ more minorities in managerial positions than any other industry, and half of all food service managers and administrative personnel are women.

These members of our society are those least able to withstand economic dislocation. In addition, a huge percentage of young adults found their first employment in the food service industry.

I would like to turn for a moment to the public policy questions which should be addressed. The first stated goal of Treasury I was economic neutrality. A portion of Treasury I's proposal reads:

> An ideal tax system would, however, interfere with private decisions as little as possible. Any deviation from this principle represents implicit endorsement of governmental intervention in the economy and an insidious part of the industrial policy is based on the belief that those responsible for tax policy can better judge than the marketplace what the consumer wants.

The Treasury II proposal violates this principle of economic neutrality by deliberately interjecting tax considerations into the business decisionmaking process. The individual who has found the business marketing meal to be an effective tool to enhance business relationships and generate economic growth will be penalized.

Anyone who has capital at risk is currently entitled to this deduction in the same manner that deductions are allowed for the cost of labor, raw materials, rent, or promotional activities. These are legitimate expenses of doing business. The Treasury Department hasn't told the businessperson that it's a good idea to cap deductions for newspaper ads to one-quarter of a page, or only 30 seconds of a spot on television, but the proposal places an arbitrary cap on a legitimate business decision, the decision to use the business marketing meals.

Business marketing meals, hospitality suites, and business-sponsored receptions which are all proposed to be nondeductible under the proposal are all a part of the marketplace. If business women and men did not believe that these expenditures had a credible impact on their business, they simply would not be made. If a businessperson is frivolous, lavish, or extravagant in the utilization of these promotional tools on behalf of his or her business, the free market has a ready answer. These businesses do not remain competitive, and the marketplace forces them to change their ways or go out of business.

The current IRS regulations already prohibit lavish or extravagant expenses as well as the expense which cannot be supported as being business related.

In closing, Senator Bumpers, I'd like to emphasize that as an industry we believe that we have been unfairly singled out for an adverse impact by the proposal to cap business meals. As such, our members are united in opposition to the placing of an arbitrary cap on what should be a business decision of business people for ensuring their best interests. The question must be asked, "Is it a responsible and productive tax policy to enact legislation which reduces an industry's sales volume, eliminates jobs, and decreases Federal, State, and local revenues all in the name of populism?" We respectfully submit to you that the answer is no.

Senator BUMPERS. Maurice, thank you very much. All the statistics you've put in your statement here are very impressive.

[The prepared statement of Mr. Lewis follows:]

SENATOR DALE BUMPERS
FIELD HEARING ON TAX REFORM

TESTIMONY ON
CAPPING THE DEDUCTIBILITY OF BUSINESS MARKETING MEALS

PRESENTED BY
MAURICE LEWIS
EXECUTIVE VICE PRESIDENT
ARKANSAS HOSPITALITY ASSOCIATION

AUGUST 27, 1985

I. INTRODUCTION

The Administration's tax reform proposal calls for limiting the deduction allowable for a legitimate business marketing meal. In addition, it would completely eliminate all deductions for business entertainment other than meals.

The Administration's key argument in support of tax reform is that tax considerations should not influence business decisions. For example, buildings should be built because it makes economic sense, not because they provide a tax shelter. We applaud these goals.

However, when it comes to the business marketing meal, this tax reform proposal violates its own goal of economic neutrality and deliberately injects tax considerations into the business decision making process.

Those responsible for tax policy are attempting to judge better than the marketplace how promotional and goodwill dollars are to be spent. In the process, they are penalizing the business person who has found the business marketing meal to be an effective tool to enhance business relationships.

Many business organizations produce goods and services that are not designed for the mass market and cannot effectively use the mass media to promote their wares of services. The local realtor or insurance agent, manufacturers of products used to make other products, suppliers of specific services to business and industry and others often must use one-on-one contact to market their goods and services. The business marketing meal provides the environment for mutual understanding and respect. Business is enhanced or new business is created.

Anyone who has capital at risk is currently entitled to this deduction (as are his agents) just as he or she is entitled to deductions for the cost of labor, raw materials, rent, or promotional expenses. They are all legitimate expenses of doing business.

The business marketing meal, hospitality suites and business sponsored receptions are all part of the marketplace. (The last two would be completely non-deductible under the proposal.) If businessmen and women did not believe these expenditures were good for their businesses, they simply would not be made. If a business is frivolous, lavish or extravagant in the utilization of these promotional tools, the free market has a ready answer: these businesses do not remain competitive--they change their ways or go out of business.

Some members of the public--and some in the Treasury Department--apparently believe the business marketing meal is simply an uncontrolled waste of money. President Carter's "Three Martini Lunch" comments helped foster this attitude.

However, that belief flies in the face of common sense and good business judgment. Business meals are budgeted within the business like every other business dollar. The budget for business marketing meals competes for priority with every other budget item. Whether that budget process is formal or informal is irrelevant. The bottom line is: If the business doesn't think it is a good idea, it simply does not spend the money.

Each company controls business marketing meal costs as they control all other costs of doing business--carefully.

II. ECONOMICS

Chase Econometrics examined the tax reform proposal with and without the business meal limitations. Their study contains findings as to its impact on workers and firms in the restaurant industry, on other parts of the economy, and on the budgets of federal, state, and local governments.

Effect upon Industry and Employment

Business meals purchased either for travel or marketing account for about one-third of total U.S. restaurant sales. Business marketing meals account for just over one-fifth of restaurant sales nationally and a substantially higher share of restaurant sales in major cities. Business meals are a recognized, productive cost of doing business. In 1985, business and professional firms will spend over $30 billion for marketing meals in U.S. restaurants, supporting some 1.3 million restaurant jobs.

The President's proposal would place a cap of $25 per person (including taxes and tips) on business marketing meal costs which could be deducted as a normal business expense. Amounts above the cap would be only 50 percent deductible. The cap would not be indexed for inflation, so the share of business meals affected would increase over time.

Based on a nation-wide survey of 55,000 households by NFO Research, approximately 18 percent of today's business marketing meal occasions, accounting for 43 percent of total dollars spent nationally, exceed the proposed cap. With 4 percent inflation, the share of business meals affected by the cap would rise to 25 percent of meal occasions, in 1988 accounting for 54 percent of total dollars spent nationally. In major cities, where rent and other costs are higher and average restaurant tabs are correspondingly larger, the impact would be much greater.

According to the latest national survey of business meal and lodging costs by the accounting firm of Laventhol & Horwath, the average cost of an evening meal at a typical hotel restaurant is already above the proposed cap in 49 major U.S. cities. Laventhol & Horwath based its survey (Table I) on a downtown hotel restaurant dinner consisting of shrimp cocktail, prime rib and vegetables, ice cream and coffee. No alcoholic drinks were included. The survey showed that even in a city like Little Rock, the average cost of a business dinner could easily exceed the proposed cap.

TABLE I
LIST OF CITIES WHERE DINNER COST (Including Tax and Tip) IS ABOVE $25.00

	CITY	DINNER	15% TIP	TAX	TOTAL
1	New York	$38.36	$5.75	$3.16	$47.27
2	Washington, DC	28.28	4.24	1.70	34.22
3	Santa Barbara	26.57	3.98	1.73	32.28
4	Dallas	26.42	3.96	1.62	32.00
5	San Francisco	26.04	3.91	1.69	31.64
6	Chicago	26.03	3.90	1.56	31.49
7	Buffalo	25.50	3.82	2.04	31.36
8	Seattle	25.28	3.79	2.00	31.07
9	Houston	25.53	3.83	1.56	30.92
10	Newark	25.33	3.80	1.52	30.65
11	New Orleans	24.53	3.68	2.21	30.42
12	San Antonio	25.15	3.77	1.41	30.33
13	Nashville	24.88	3.73	1.37	29.98
14	Austin	24.57	3.68	1.26	29.51
15	Philadelphia	24.09	3.61	1.44	29.14
16	Columbus	24.08	3.61	1.44	29.13
17	Atlanta	24.20	3.63	1.21	29.04
18	Wilmington	24.29	3.64	1.09	29.02
19	Richmond	24.33	3.65	0.97	28.95
20	Los Angeles	23.81	3.57	1.55	28.93
21	Minneapolis	23.81	3.57	1.43	28.81
22	Baltimore	23.91	3.59	1.19	28.69
23	Dayton	23.52	3.53	1.41	28.46
24	Denver	23.40	3.51	1.54	28.45
25	Rochester	23.16	3.47	1.62	28.25
26	Boston	23.42	3.51	1.17	28.10
27	Detroit	23.41	3.51	0.94	27.86
28	San Jose	22.58	3.39	1.58	27.55
29	Miami	22.80	3.42	1.14	27.36
30	Cleveland	22.47	3.37	1.46	27.30
31	Hartford	22.20	3.33	1.66	27.19
32	Phoenix	22.63	3.39	1.13	27.15
33	Tulsa	22.33	3.35	1.34	27.02
34	Corpus Christi	22.40	3.36	1.15	26.91
35	Fort Lauderdale	22.33	3.35	1.34	26.80
36	Pittsburgh	21.75	3.26	1.30	26.31
37	Norfolk	22.08	3.31	0.88	26.27
38	Baton Rouge	21.40	3.21	1.50	26.11
39	Lexington	21.67	3.25	1.08	26.00
40	Little Rock	21.65	3.25	1.08	25.98
41	Fort Wayne	21.61	3.24	1.08	25.93
42	Cincinnati	21.50	3.22	1.18	25.90
43	San Diego	21.36	3.20	1.28	25.84
44	St. Louis	21.06	3.16	1.26	25.48
45	Greensboro	21.32	3.20	0.96	25.48
46	Indianapolis	21.05	3.16	1.05	25.26
47	Albany	20.70	3.10	1.45	25.25
48	Columbia, S.C.	21.00	3.15	1.05	25.20
49	Memphis	20.51	3.08	1.59	25.18
50	Albuquerque	20.90	3.13	0.97	25.00

Sources: Dinner cost, "Corporate Travel Index, 1985," Laventhol & Horwath./ Local sales tax and tip computed by NRA.

As one can see, if 50 cities are in this class today, it will not be long until most commercial centers are affected by this proposal. It should be noted that the costs of the meals in downtown hotels are somewhat below those of the top independent restaurants in a city.

The actual dollar value of business meal expenditures above the proposed cap would rise from about 17 percent today to about 22 percent in 1988 just due to inflation. When tax and tip are included along with inflation, the actual menu price of a business meal in 1988 would have to be less than $17.15 in today's prices to avoid the cap.

Reducing the deductibility of business meal costs above the cap to 50 percent will make business meals relatively more expensive than other marketing expenses that continue to be fully deductible. Since business meal purchases are extremely price sensitive, the result will be a sharp reduction in meal expenditures affected by the cap and a corresponding reduction in restaurant sales and employment. Studies prepared for Treasury's Office of Tax Analysis indicate that spending on business marketing meals declines by two to four percent for every one percent increase in their relative price. Reducing the deductibility of meals over the proposed cap to 50 percent is equivalent to an increase in their relative price of 24 percent. Hence, the proposed $25 per person cap would result in a reduction of 50 to 85 percent in purchases of business meals above the cap price and in a drop in total business marketing meal purchases on the order of 9 to 15 percent nationally. The drop would be much greater in metropolitan areas where the number of business meals above the cap is proportionately much larger.

The impacts of the proposed cap shown in Table II are based on the low-end estimate of a 9 percent reduction in business meal purchases nationally, compared with the level of business meal purchases which would occur under "Treasury II" without the business meal cap. During the first three years--1986-1988--direct losses in restaurant sales would total $11.9 billion and direct losses in restaurant employment would total nearly 460,000 person-years. The reduction in restaurant sales would produce a direct reduction in state and local sales tax receipts of over $700 million.

When indirect effects are taken into account, using the Chase Econometrics U.S. Macroeconomic Model, total U.S. employment would be reduced by 580,000 person-years during the first three years. Federal corporate taxes would rise about $5.4 billion during this period, but this increase would be more than offset by lower tax receipts from individual taxpayers and higher expenditures due to the increased unemployment created by the cap. Federal receipts from personal income taxes and social security taxes would fall by $2.2 billion and $2.4 billion, respectively, while transfer payments would rise by nearly $2.4 billion. As a result, the net financial position of the federal government would be worsened some $2.8 billion in the initial three year period if the cap is imposed.

Impact upon State, Local and Federal Revenues

The impact on state and local governments is even greater. Nationally, when indirect effects are taken into account, total state and local tax receipts would be reduced by $2.8 billion in the initial three-year period. When higher expenses due to higher unemployment are factored in, the net financial position of state and local governments would be worsened by more than $3.2 billion.

Even though Treasury claims the business meal cap has only a "small revenue impact," the cap widens the federal deficit and substantially worsens the adverse impact on state and local governments. When the impacts on federal, state, and local budgets are combined, the total net deficit during the initial three-year period is just over $6 billion.

The adverse effects of the proposed business meal cap are aggravated further by their timing relative to the proposed rate reductions included in other parts of "Treasury II." The cap would go into effect on January 1, 1986, while the rate reductions would be delayed until July 1, 1986, or perhaps even later. The impact of the cap is very sensitive to the marginal tax rate of individual and corporate taxpayers at the time the cap is activated. The higher the marginal tax rate, the greater the shift in the relative price of business meals when a cap on deductibility is imposed. Imposing the cap at the current marginal tax rates six months before the proposed rate reductions take effect worsens the impact by over $300 million in additional lost restaurant sales during 1986 and some 13,000 additional jobs lost in the restaurant industry during 1986.

The job losses would severely affect foodservice employees. Our industry is one of the largest employers of teens, women and minorities. Our industry employs more minority managers than any other industry, and half of all foodservice managers and administrative personnel are women. These are members of our society least able to withstand economic dislocation.

TABLE II

ECONOMIC IMPACT OF BUSINESS MEALS CAP UNDER "TREASURY II"

(with meals cap versus without)

	1986	1987	1988	Total
Direct Impacts on Sales, Employment, and Tax Receipts*				
SALES OF MARKETING MEALS ($ Billions)				
Total Projected Sales	33.2	36.8	40.7	110.7
Sales Lost Due to Cap	-3.5	-3.8	-4.6	-11.9
Sales Retained	29.7	33.0	36.1	98.8
DIRECT EMPLOYMENT (Thousands)				
Eating & Drinking Establishments	-144	-146	-166	-457
DIRECT TAX RECEIPTS ($ Billions)				
Federal Tax on Meals Over Cap	.25	.28	.26	.79
State & Local Sales Tax on Meals	-.21	-.23	-.27	-.71
Macroeconomic and Government Revenue Impacts, including Indirect**				
GNP ($ Billions)				
Current Dollars	-1.7	-3.31	-5.84	-10.85
1972 Constant Dollars	-.65	-1.1	-1.57	-3.32
EMPLOYMENT (Thousands)				
Total U.S.	-150	-190	-240	-580
Wholesale & Retail Trade	-150	-160	-190	-500
Unemployment Rate (Percent)	.09	.1	.11	na
FEDERAL BUDGET ($ Billions)				
Personal Income Taxes	-.51	-.69	-.99	-2.19
Corporate Income Taxes	.85	.87	3.63	5.35
Social Security Taxes	-.53	-.73	-1.06	-2.32
Total Federal Taxes	-.19	-.55	1.58	.84
Transfer Payments	.87	.76	.72	2.35
Federal Net (deficit)	-.87	-.79	-1.17	-2.83
STATE & LOCAL BUDGET ($ Billions				
Personal Income Taxes	-.34	-.49	-.7	-1.53
Corporate Income Taxes	.13	.12	.11	.36
Indirect Business Taxes	-.37	-.52	-.73	-1.62
Total S&L Taxes	-.58	-.89	-1.32	-2.79
State & Local Net	-.69	-1.07	-1.46	-3.22

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* Estimates prepared by Shriner-Midland Company.

** Macroeconomic simulations by Chase Econometrics.

IV. COMPLIANCE

A staff study of tax reform by the Joint Economic Committee, published November 29, 1984, identified "compliance" as one of the major principles upon which to judge tax reform proposals. The Joint Committee defined compliance by stating, "The tax system should minimize the incentive and opportunity for taxpayers to evade taxation by underreporting income or overstating deductions and exemptions."

Referring to the compliance problem of our present tax system, the committee print states that "tax reform proposals could improve compliance in two ways -- by eliminating preferences that taxpayers can misuse to shelter income and by reducing tax rates to reduce the incentive to cheat. Should this fail to make a significant improvement in compliance, tax reform will have to be supplemented by increased enforcement." (S. Print 98-253, Nov. 29, 1984, p. 20)

The provisions limiting deductions for legitimate business marketing meal expenses are supported by the Treasury Department as a means of promoting compliance by increasing the "perceived fairness" of the tax code. Since many workers do not make use of business marketing meals to promote themselves or a product, Treasury officials disapprove of such promotional activity by others. Authors of this provision point to a series of field hearings conducted during 1984, where complaints were heard from citizens about entertainment costs being written off as business-related. These same objections could be directed at the large and well-furnished office suites maintained by many companies in high-rent cities, or the use of expensive hotel suites by business executives conducting business away from home.

These business people, however, conduct business in this manner because that is what is expected in their particular lines of business and at the level at which they compete. Most are not operating in a manner calculated to overstate deductions. Therefore, Treasury's proposed caps and limitations do not get at the real compliance problems of overstating deductions and underreporting income. They are merely a political attempt to address a "perception" of unfairness which arises out of both legitimate and illegitimate uses of expense account spending.

In order to get at the real abuses in business entertainment and business marketing meal occasions, legislation or committee language would have to address the specific problem of overstatement of deductions. This overstatement occurs if and when a taxpayer claims a deduction for a business marketing expense which is actually a personal expense that is not business-related. These types of abuses can only be identified and reduced through increased use of audits, and increased publicity surrounding the results of audits.

In fact, the IRS does have the authority under existing law and regulations to disallow deductions for expenses which are not justified as business related, or which are lavish and extravagant.

The IRS has successfully brought cases to deny improperly taken deductions. Both sections 162 and 212 of the Internal Revenue Code require that the expense must be "ordinary and necessary" in order to be deductible.

The Treasury proposal in fact creates a compliance nightmare of its own. It vastly increases the difficulty of recordkeeping by forcing the honest business person to sort out, and keep track of, that portion of business marketing meal expenses which are fully deductible and that portion which is partially deductible.

Unfortunately, the opportunity for fraud is increased. If we see "tables for two and checks for three," or the invention of several imaginary dinner guests as the answer to the paperwork and deductibility dilemma, can we say this will improve the public's "perception" of fairness? The answer, of course, is no.

V. CONCLUSION

The Treasury Department argues that it is unfair for a "limited class of taxpayers" to engage in activities which have some element of personal consumption. However, the "limited class of taxpayers" who use the meal as a marketing tool are any taxpayers, or their agents, who have capital at risk.

As our elected representative to the U.S. Senate, you understand the workday of the entrepreneur. Those who serve in Congress, like those who compete in the marketplace, whether seeking voter exposure or business expansion, do not punch time clocks and cannot always control their hours of work.

When a businesswoman engages in a business lunch, it means her business day is extended through the lunch hour. When a businessman engages in a business dinner, it means he didn't go home at five o'clock when the factory whistle blew.

The number of jobs at stake over this issue is enormous. The deductibility of the business marketing meal affects not only those 144,000 foodservice positions that would be lost in the first year of enactment but thousands of other American workers whose jobs were created or retained because of a contract closed over a business marketing meal.

In closing, Senator, I ask you: Is it responsible and productive tax policy to enact legislation which reduces an industry's sales volume, eliminates jobs and decreases federal, state and local revenues all in the name of "populism?" I respectfully submit to you that the answer has to be an emphatic no.

Thank you, Senator, for holding these hearings and permitting our views to be heard.

Senator **Bumpers**. Let me ask you this for openers. At one point here, I understood you to say the total job loss that we would expect if the President's tax proposal went into effect is 580,000 person years. In another place here, I believe, it's on the next to the last page, you mention a different job loss figure, 140,000 jobs lost the first year.

Mr. **Lewis**. Yes, sir.

Senator **Bumpers**. What is the difference in those two figures?

Mr. **Lewis**. I don't know if I understand that either. I'm sorry. You're talking about the employee years?

Senator **Bumpers**. On the last page of your statement you say, "The number of jobs at stake over this issue is enormous. The deductibility of the business marketing meal affects not only those 144,000 foodservice positions that would be lost in the first year of enactment." At another point, I understood you to say that this proposal would cause the loss of 580,000 person years, which it would seem to me could cause a 180,000-job loss in the community.

Mr. **Lewis**. Yes, sir, Senator. We're talking about the residual effect, I guess, the rippling effect when you lost 144,000 jobs. In that particular industry, it has to have a rippling effect because when these people purchase——

Senator **Bumpers**. I see.

Mr. **Lewis** [continuing]. And provide jobs in other areas.

Senator **Bumpers**. Maurice, I'm going to ask you one question, which incidentally I will ask every witness this morning and I hope you have thought about it enough to state a conclusion on behalf of your organization, but it is this. If you had to choose between the current Tax Code and the tax reform package which, of course, has fewer deductions but lower tax rates, which would you take?

Mr. **Lewis**. Senator, I would prefer the current Tax Code if the proposal means that we're going to eliminate some of the proven deductions that have continued to generate revenues and jobs.

Senator **Bumpers**. Let me ask you another question. Do you have any feelings one way or another about the fact that the tax proposal substantially raises corporate taxes and on the other hand gives personal tax cuts?

Mr. **Lewis**. Senator, that's a broad question, but I can say, if it ain't broke, don't fix it. And I think that in this particular situation, the system seems to be working fairly well.

Senator **Bumpers**. So you'd just as soon leave things the way they are?

Mr. **Lewis**. I would.

Senator **Bumpers**. You know the Finance Committee office is right next to my office. When they hold hearings on this tax bill, I can hardly get down the hall to go vote. I told Bob Dole I was going to start holding fundraisers out in the hall. It looked like a good place to me. He said that everyone's for tax reform "but," and so far the "buts" are winning. And he has said—of course, he is not chairman of that committee anymore. Senator Packwood is, but Senator Dole is the majority leader, of course, and a very able spokesman—that because of the "buts," he would evaluate the chance of tax reform as probably less than 50-50 right now.

Maurice, what paperwork burdens would this tax proposal—as far as restaurants are concerned—what paperwork burdens does that impose on them and their customers?

Mr. **Lewis**. I defer that to Don Phelan, who is on the National Restaurant Association's board of directors and is in the restaurant business.

Mr. **Phelan**. I don't seek that it would increase our paperwork any at all.

Senator **Bumpers**. How about the businessman who does quite a bit of entertaining? There's a cap here, a $25 limit on a meal deduction, which would require some paperwork to calculate. In most places, unless you go to the Four Seasons restaurant in New York, $25 for a lunch is certainly enough.

Mr. **Phelan**. We're concerned, I think more than the initial $25, that the $25 will be $20 next year, $15 the next year, and $10 the next year.

Senator **Bumpers**. But on the question of paperwork the proposal is that if you spend $50 for a meal, the first $25 is deductible and half of the excess over $25 is deductible. That's the proposal. Does that create any kind of a paper burden on the business community?

Mr. **Phelan**. I would think it would definitely create a burden on the business community, not the individual restaurant.

Senator **Bumpers**. Let me ask both of you this. You know, Jimmy Carter used to talk about the three-martini lunch. I must confess that I find that type of lunch a little bit obnoxious. I don't know of any people who ever indulge in that, but the picture is not a flattering one.

Mr. **Lewis**. That's a myth, Senator. I think one of the concerns of the food service industry and the hospitality industries nationwide is the history that, if you will pardon the expression, the Government has never gotten a tax it didn't like or one it didn't hike. We're very concerned, as Mr. Phelan said, that obviously $25 cap in the State of Arkansas, and we have done some research, has an effect on very few people at this time. But the precedent is set by the $25 cap. We feel that it's very possible that it may very well be $20, or for that matter, with tax and tip and the present growth of inflation in the last 10 years, we don't know when the average, we're talking about a banquet meal, that may not be $25. Some of—in most areas it's not $25 for a banquet dinner. So we're concerned about that, the inflation growth, even more so, as Mr. Phelan said, about it being $20 next year, 2 years from now $15 to $10. In that respect we're looking at a tremendous amount of loss and obviously paperwork on the——

Senator **Bumpers**. So your main concern is not what the proposal does now, but where you're afraid it's going to lead?

Mr. **Lewis**. Well, yes, sir, both because in this particular instance we're probably looking at 3 percent of the industry in the State at this point. But that 3 percent does a tremendous amount of volume. I'd say that the 3 percent may do as high as 15 percent of the total volume of food service in the State. And under those circumstances it would be a severe blow even today even if we didn't consider what could happen in the future.

Senator **Bumpers**. Maurice, what, if anything, do you think can be done to change the public's—change the image of a lot of wealthy people having very expensive tax deductible lunches? I think of President Carter because he hammered on that image so hard and now President Reagan seems to be after it, too. I think there is a perception, correctly or incorrectly, across the country that a lot of people do abuse the deductibility of business meals. What, if anything, would you suggest be done to overcome that idea?

Mr. **Lewis**. If I understand it correctly, you mean that——

Senator **Bumpers**. Really, I'm talking about a kind of public relations problem because there are a lot of people who never deduct a meal who feel that it's unfair for others to deduct their meals. How would you go about that?

Mr. **Lewis**. It's a marketing tool and obviously, Senator, it's a matter of trying to educate, I suppose, people of just what the economy is and how it functions and how it rotates and how the dollar moves. But, in brief, what we're talking about is a marketing tool. When someone brings a potential prospective customer or buyer to a restaurant, then it's a marketing tool as much as if you were advertising in one of our media. But further than that, what is happening is that in—when this person takes that deduction, it would seem that he's not paying taxes, but when you look at the fact that he is providing a job for one or two people, and you multiply that, as we say in the statement, to 144,000 people—when you look at what is being generated economically speaking from those jobs and those 144,000 people, then that in turn generates jobs because they're spending their money and the tax dollar continues to flow.

If we had an answer, it would hopefully be, and I've been saying this for many years, that we must start teaching the basics of economics and how the dollar actually flows even as low as our elementary students. Other than that I guess it would just simply take a tremendous amount of expenditure through the media to explain just why this is economically sound and not a detriment to the economy.

Senator **Bumpers**. Maurice, I want to thank you and Mr. Phelan both for being with us.

Mr. **Lewis**. Thank you, sir.

Senator **Bumpers**. Our next witnesses are Gaines Norton, managing senior tax partner of Frost & Co. in Little Rock, and Sam Ludington, owner of S.R. Ludington Accountants, an accounting firm which has 10 employees. Gaines, I have your name here first, so why don't you go first?

STATEMENT OF GAINES NORTON, FROST & CO.

Mr. **Norton**. The President's tax proposals to Congress for fairness and simplicity are the keynotes used to attract the attention and support of the public, but the actual proposals are in no way simple nor are they fair.

I've made my living in the income tax section of my profession as a CPA for the last 18 years, and I've lost count of the number of tax reform measures that we've had. Every Congress has wanted to reform the Internal Revenue Code and all it manages to do in the process is make it more complex.

No Congress wishes really to spend sufficient time studying the problem that is existing in the tax law to do it justice. As an example, one recent problem we've had is the auto log rules. Congress passed that without a lot of consideration and thought, and it caused a huge groundswell.

Also Congress has abdicated its responsibility in my opinion by giving excess authority to the IRS to publish regulations. In effect Congress has told the IRS by code sections that this is the general concept of the law, and it's up to you to intrpret what we mean. If this is what Congress really wants to do, then I think Congress ought to pass the law, require the regulations be written by the IRS and then adopt the regulations by an act of Congress as opposed to letting the IRS adopt the regulations. This way Congress can see for itself whether the IRS is doing what Congress intends.

Some areas of concern that I have, especially in Arkansas, are first of all, the proposed changes to the cash method of accounting. This particular change has been sold as affecting big business, but the way the change has been proposed it does not affect just big business.

Basically, since 1913 the IRS and Congress has allowed both farmers and service businesses to report their income tax on a cash method of accounting. Simply that means that you do not pay taxes on your income until you receive it, and you do not deduct expenses until you pay for it.

The proposal has been described by many politicians and bureaucrats as requiring only corporations or only taxpayers who have more than $5 million in gross receipts to use the accrual method of accounting. First of all, there is no indexing for inflation on this $5 million. Five million today might be big in some industries or small in other industries. Also what's it going to be in 20 years?

Second of all, the $5 million limit does not apply if the business is required by their bankers or their partners or owners to publish income statements on some sort of a regular basis using the accrual method of accounting. Simply that means that if you have a plumber out here who's basically in the repair business and he goes down to the bank to borrow money and the bank says, "OK, now let's look at your financial condition", you know, "Let's fill out a balance sheet on you. What do your customers owe you? They owe you $3,000." Well, that's set up as an account receivable on a financial statement. If year in year out he has to go to the bank and do this, he is now publishing a financial statement on the accrual method of accounting. Regardless of what his income is he's going to be required to use the accrual method of accounting by the IRS.

Also, very importantly the IRS has been battling in Congress and in the courts the issue of various parties' rights to use the cash method of accounting, and also there has been a substantial amount of law changes since 1976 in the Internal Revenue Code which have narrowed down who can use the cash method of accounting. Why, once it's been narrowed down by these processes has taken 9 years, why go in and change it again.

State income tax deduction is something that's going to seriously affect small business, particularly in Arkansas. Arkansas is not a wealthy State by any means in income per capita. We are 50th in the Nation. But we're 39th in the Nation in the value of that State income tax deduction to a citizen in Arkansas.

Senator **Bumpers**. You're safe on that issue. I couldn't agree with you more.

Mr. **Norton**. Well, you were the one that pointed it out in a news article one day and there's a table published, two tables published in the President's proposal that points this out very clearly if you read it, it is a heavier load per capita in Arkansas than it is in many other States.

The No. 1 State in per capita income, Alaska, is about something like 45th in value of the deduction.

Earlier there was some discussion about paperwork loads. One of the proposals is to tax certain portions of fringe benefits paid to individuals. Now, a small business will use various methods to attract employees, one of which is to provide some fringe benefits. Now, if you're going to tax those fringe benefits, you're going to enter into the decision of an employee where to go to work based on how it's taxed, but you're also going to create substantial paperwork on that employer who now has to keep up with each indvidual employee's taxable portion of fringe benefits.

Unfortunately—and I say unfortunately even though I look forward to it, this really will cause small business to hire more professionals. There's going to be more decisions made, for example, there will be a decision by each small business owner whether he's incorporated or a sole proprietorship. That requires him to have professional help and spend more money to make this sort of decision. Specifically in the case of the State income tax deduction, a State income tax deduction will not only be disallowed for individuals, but it will also be allowed for corporations—most, not most, but a lot of small business owners are unincorporated businesses, so the income they show from their business is reported on their individual income tax return, either on schedule C or schedule F or whatever schedule is pertinent, and he will pay State income tax on that income. If he's filing a 1040, he will not be able to deduct State income tax as a business expense. If he were a corporation, he would be able to deduct the State income tax as a business expense. So he'll be put in a noncompetitive environment on that particular item compared to corporations.

Depreciation is an area that I thought in 1981 Congress finally came to grips that what we have is just an expense that needs to be written off over some period of time, whatever that period of time has to be. And in 1981 they passed the ACRS method of figuring depreciation which recognized that all you're doing is taking the cost of an asset and spreading it over some arbitrary period of time and deducting it from your taxes.

Now, why, when that was only passed 4 years ago, do they want to go in and completely revamp the system? Congress wants to adopt now the CCRX, all these buzz words, and completely change up the method for computation. If it's simply a matter of the old system being too aggressive, as some people say, why not just change the period over which you're going to write off certain assets? No, they want to go in and completely change everything.

I clearly think the Internal Revenue Code should be reformed, but I think that you need to spend sufficient time and effort to look at it and study it and see why you're changing it and not change it every year or every 4 years. If the depreciation issue was taken care of in 1981, why dig it up again and take care of it again?

I'm afraid that this measure is just once again one measure, or one more reform act that we're going to be looking at and next year another reform act, and so forth.

One last point. Unfortunately the Tax Code is such that it impacts business decisions. But I also say that the taxes as they've been passed since 1913, have not been passed to just simply collect tax from everyone. They've also been passed to create certain economic and social goals of the Congress or of the people.

I think that we need to study each particular industry and each particular tax law, see why the tax law is that way and, were there certain goals that were accomplished when passed that are still important.

Senator BUMPERS. Gaines, that's really an excellent statement. If you will just sit tight until Sam speaks. Sam, thank you for coming this morning.

STATEMENT OF SAMUEL R. LUDINGTON, CERTIFIED PUBLIC ACCOUNTANT

Mr. LUDINGTON. Our present tax law, even though it's controversial and maybe unfair, has forced people to invest where the Government needs investment, such as oil, gas, developing real estate, purchasing fixed assets, and hiring people. This was accomplished through tax incentives. In most instances these tax incentives have been passed on to the consumer. This does permit an individual to build a sizeable estate which may be unfair to the general public. Estate taxes then recovers a portion of these individual's estate. In my opinion the basic theory of our present tax structure is one reason our country has been successful.

As the tax laws have tightened on oil and gas depletion, we have seen gasoline and utilities costs skyrocket. In my opinion, the loss of tax incentives is one factor for this increase.

In addition, our tax laws have helped redistribute the wealth and partly help make up our large middle class. I'm in agreement that it does need to be restructured.

Business entertainment expenses may not be deductible under the new law. This is a direct—there is a direct correlation of growth and business promotion costs, entertainment being one of these production costs. Entertainment costs have been greatly abused. However, it appears to me that a small business owner's partner should stand its share of the costs. In our area the meals and travel appear to be high enough to cover the cost incurred by the average business owner.

ACRS depreciation is too fast, and accordingly the new life under the President's proposal is probably more fair to the average business than it is today. Now, as far as simplification, how can indexing be simplification? The law, as I understand it in reading what the President has put out, indicates that Congress is going to determine what the indexing factor's going to be every year. If it is indexed, it should be tied to something like the CPI, Consumer Price Index. The calculation must be kept simple such as it's got to help protect us from the inflationary spiral we were in in 1970, so I think it's really necessary.

Now, the investment tax credit appears to be a device that Congress has used to regulate the economy. ACRS depreciation and the investment credit provides for an individual to get up to 17½ percent of the purchase price in tax reductions in the first year he places a piece of equipment in service. In reality, his partner, the Government, is providing the down payment. Accordingly, I feel that the investment credit is necessary for small business.

The investment credit has had numerous changes, increases in the amounts, taking it out of service, putting it back in, and each time it's adjusted to try to do something to the economy. So I think serious consideration should be given to the history of these changes on the economy before abandoning this credit.

Indexing of inventory for small businesses would have helped them drastically in the late 1970's. The small businessman was not able to keep his balance sheet properly balanced between current liabilities, long-term liabilities, and equities because of the inflationary spiral. This imbalance has had some affect, in my opinion, on the small businessman's difficulties in the 1980's. The indexing of inventory should help eliminate this situation. The formula for determining the index deduction for inflation should be simple, such as beginning inventory times the CPI equals—CPI increase equals index deduction. If the law requires that this computation should be made on a unit basis, the computation would force most businesses not to use the formula. In my opinion, the calculation of this deduction should be kept simple.

It appears that few small businesses would be affected much by the windfall profits tax.

Elimination of the installment sale deferral and bad debt reserves would require they change the balance sheet accordingly. They would have to put in more working capital and pay a little bit more interest.

The cash method of accounting should be continued for small businesses that are required to make their financial statement on some other basis. This is consistent with what they've done in the past and probably does a fair job in matching income and expense and I think it should be continued.

In summary, the proposed law benefits the rich, rate reduction times the income, and the large corporation, tax rates, indexing and dividends. The average small business, being in Sebastian County those having four or less employees, which would indicate that their income is less than $75,000 a year, would pay more tax under the new tax law except in high inflationary years because of the rate reduction which would be practically nonexistent for corporations making less than $75,000 would not offset the credits and deductions lost. It would be more difficult for the small business to purchase equipment since the Government would not provide the downpayment. Because of the increased tax, loss of downpayment to purchase equipment, and the complexities of indexing, planning and computing, I think the new tax law is a disadvantage to small business.

Senator Bumpers. Sam, thank you very much, and I thank both of you for very good statements.

[The prepared statement of Mr. Ludington follows:]

Statement of
Samuel R. Ludington, Jr.

Before: Senate Committee on Small Business

Subject: The President's Tax Reform Proposal

Date: August 27, 1985

Place: Fort Smith, Arkansas

My name is Samuel R. Ludington, Jr. and I am a Certified Public Accountant in private practice in Fort Smith, Arkansas. In addition, I have a retail operation and an apartment complex.

I am pleased to be appearing before you today on the subject of the President's tax reform proposal and its impact on small businesses.

Our present law, even though it has become quite burdensome and unfair, has forced people to invest where the government needs investments, such as oil and gas, development of real estate, purchasing fixed assets and hiring people. This was accomplished through special tax incentives. In most instances, the tax savings have been passed on to the consumer.

This does permit an individual to build a sizeable estate, which may be unfair to the general public. Our estate taxes then recover a portion of the individual's estate. In my opinion, the basic theory of our present tax structure is one reason our country has been successful.

As the tax laws have tightened on oil and gas depletion and intangible drilling costs, we have seen gasoline and utility cost skyrocket. In my opinion, the loss of tax incentives is one factors for this increase.

In addition, our tax laws (income and estates) help redistribute the wealth. This being one of the factors in creating our large middle class society.

However, I am in agreement that a major tax reform does need to be enacted. This is primarily because several of the tax laws added to the code for special interest groups provide no economic value to the country.

Business entertainment expenses will not be deductible under the new tax law. There is a direct correlation with growth and business promotion costs, entertainment being one of your promotion costs. Entertainment expense has very obviously been grossly abused, and maybe the only way to correct it is to make it not deductible. However, it appears to me that the small business owner's partner should stand its share of this operating cost.

It appears that the President's proposal of business meals and travel appears to be fair. The limitation on business meals and travel appears to be high enough that they should not affect the average small business onwer.

ACRS depreciation is too fast. We are approaching the time when certain businesses which have acquired fixed assets on time payment will be paying for the asset with no deduction for depreciation to offset principal payment. ACRS depreciation for these people was great until now. The President's proposed law is nearer economic life and should be better than ACRS. Adjusting the annual depreciation deduction for inflation should help management provide the funds to continually update their plants and equipment. The indexing factor should be tied to a defined factor (such as the CPI) rather than a factor Congress determines annually. This calculation must be simple and not require a computer to calculate. I feel that the indexing of deductions, after going through the inflationary spiral of the late 1970's, is a necessity in our tax law.

Investment tax credit appears to be a device that Congress has used to help regulate the economy. ACRS depreciation and the investment tax credit provides for an individual to get up to 17 1/2% of the purchase price in tax reductions in the first year he places a piece of equipment in service. In reality, his partner, the government, is providing the down payment. Accordingly, I feel that the investment tax credit is necessary for small business.

The investment credit was placed in service in 1961. It was suspended in October 10, 1966 and reinstated on March 9, 1967. It was again repealed April 18, 1969 and reinstated in 1971. The percentage was raised from 7% to 10% on January 22, 1975 and the 1981 Act again increased the investment tax credit. The repeal of the invesment credit on October 10, 1966 and April 18, 1969 resulted in a depressed economy shortly thereafter. The reinactment of investment credit on March 9, 1967 and January 1, 1971, and the raising of the credit on January 22, 1975 and January 1, 1981 was the result of Congress trying to feed the economy because of the recession we were in. Serious consideration should be given to the history of these changes on the economy before abandoning this tax credit.

Indexing of inventory would help the small businesses drastically. In the late 1970's, the small businessman was not able to keep his balance sheet properly balanced between current liabilities, long-term liabilities and equity because of the inflationary spiral. The imbalance has had some affect, in my opinion, on the small businessman's difficult time in the 80's. The indexing of FIFO inventory should help eliminate this situation. The formula for determining the index deduction for inflation should be simple, such, as: Beginning inventory X CPI increase = Index Deduction. If the law require this computation to be made on a unit basis, the computations would force most small businesses not to use the formula. In my opinion, the calculation of this deduction should be kept simple.

It appears that only a few small businesses would be subject to the windfall profits recapture provision.

Elimination of the installment sale deferral and bad debt reserves would require the small business owner to have additional working capital and, accordingly, increase his interest expense. Since the small businessman is having an extremely difficult time at this time, I feel that these items should be continued in the President's proposal.

Cash method of accounting should be continued for the small business with sales under five million dollars which give periodic statements to the bank on the accrual accounting method. In general, most small businesses maintain their books on a cash basis. In some instances, they are required to convert to an accrual basis for presenting finanicial statements to financial institutions. Because of this conversion required for debt, I do not feel that it is fair for the small business to be restricted from using the cash method of reporting.

In summary, the new law benefits the rich (tax rate reduction X Income) and the large corporations (tax rates, indexing and dividend). The average small business would pay more tax under the new law (Except in high inflation years) because the rate reduction would not offset the credits and deductions lost. It would be more difficult for small business to purchase equipment since the government would not provide the down payment. Because of increased taxes, loss of the down payment to purchase equipment, and the complexities of indexing (Planning and Computing), I think the new law would be a disadvantage to small business.

Senator **Bumpers**. Sam, let me just ask you this question, which you heard me ask Maurice earlier. If you had to choose between the current Tax Code and the present tax reform proposal, considering everything, which would you prefer?

Mr. **Ludington**. I don't think either one of them should be. I think the present tax law in theory is a good device. I think that a whole bunch of these special interest group amendments that have been passed in the last 5 years should be eliminated and the law should be simplified. I don't think either one of them is good.

Senator **Bumpers**. Well, how do you feel about the increase in business taxes, for example, to offset the decrease in personal taxes?

Mr. **Ludington**. I think the increase in business tax will be passed on to the individual if they have time to do it. If they can't get it passed on, I think a bunch of them are going to go broke.

Senator **Bumpers**. Gaines, would you comment on those two quetions?

Mr. **Norton**. Yes, I would. If I had to choose between the two presently, I'd choose the current tax law with the understanding that each section would be looked at and revised accordingly, considering everything that we've tried to accomplish in the past.

Seven years ago Congress decided that this was wise and started a study of each section of the code, each major subtitle section, and passed revisions with the goal of revising those sections. We've had Subchapter S Tax Revision Act of 1981, I believe it was. Right now they are actually working on those sections, also subchapter C corporations. That goes right over the top of most people when you start talking about code sections and subtitles, but this is what needs to be done, just study each section and revise the individual section. As far as raising corporation and lowering individual taxes, I mean there's only one thing that can happen, you're increasing business expenses. So you're going to reduce the return that corporation's business is going to have. It's either going to have to be absorbed by the corporation, passed on to their customers or they'll go broke.

Senator **Bumpers**. It'll also reduce their ability to compete in a fiercely competitive international market. Of course, that's true only for some small businesses.

Mr. **Norton**. And one other thing, too, Senator, is that a lot of these provisions, like for instance the cash method of accounting which is allowed for large farming corporations or for anybody really, but particularly large corporations, only for family owned companies. Well, now, if you—they're at a competitive disadvantage when they have to go to the marketplace to obtain capital. If I owned a company and I was lucky enough to have more than $5 million in receipts in the farming business, I would be in a competitive disadvantage compared to a public company in that same business. So—and that's what I was getting at in my remarks about the difference in social and economic goals.

Senator **Bumpers**. Gaines, if I might just comment on just one thing that you said in your opening statement. You said that you think that Congress gives the IRS excessive auhority. It doesn't give excessive authority just to the IRS, it gives it to virtually all of the bureaucrats. What it does is it passes a one sentence law, as we did in the case of the automobile recordkeeping law, and the IRS comes out with a hundred different regulations to implement that one sentence law. As long as nobody says anything about the regulation, Congress is fine. What it has done is to pass the political pressure over to the bureaucrat and let him abosrb the heat. If the heat gets too heavy, then Congress comes back, as we did in the case of the automobile law, and repeal the law or bar the regulation. Of course, that's why I've always felt that regulations ought not to be presumed to be valid. I think tht small business people, especially, ought to be able to challenge government regulations and if they win, they ought to be able to get their attorney fees, and all their court costs.

Mr. NORTON. That's putting a lot of burden on one individual business to do that.

Senator BUMPERS. Those people who write those regulations, they do it thinking they can hide behind the court always assumes, and this is the precedent, the validity of a regulation. Then the poor guy that's challenging the regulation, the small businessman, for example, has to overcome that presumption. So the burden is on him to prove that the regulation is invalid; but the burden should be on the agency to prove that the regulation conforms to the intent of Congress. They'd be a lot more circumspect in writing those regulations if there was no presumption. You really hit a nerve when you mention that. I've always said that the people in this country still do rule. Withholding taxes on interests, that was a case in point. People just went bonkers when they started talking about withholding taxes on interest income. And people went crazy on the automobile law and it just took Congress about a New York minute to repeal that.

And if the people of this country ever get this upset about the deficits as they did about those two things, I promise you that Congress will respond in the same way. It's tragic that they really haven't seen how disastrous these deficits are to our country. As I said, everybody wants to balance the budget, "but . . .".

Anyway, Sam, you mentioned one other thing that sort of hit a nerve with me, and that's the question of inflation indexing. I think that the indexation of inventories make sense. Then you can get away from that difference between LIFO and FIFO. But I have generally been opposed to the indexation of income tax brackets, not because I don't think it's a good idea. I think it has a powerful argument for it, but I oppose it for two reasons. No. 1, right now, we can't afford it. If we index tax brackets you just exacerbate the deficit problem. And No. 2, the countries in the world which do index, like Israel and Brazil, have gotten so used to high inflation rates that they don't really much care what the inflation rate is. The only courtry that has had any success at all with indexation is Canada.

So, I have problems with that, but I will agree with you that if we're going to do it, it ought to be simple and probably CPI, the Consumer Price Index, ought to be used as the criteria.

Now, Sam, I don't know if you have any clients that this affects or not, but let me ask you this: One of the hottest questions in Congress right now—and I really think this is more a big business issue than it is small business issue, and maybe we don't want to spend too much time on it—is the recapture provision of this bill. How do you feel about that?

Mr. LUDINGTON. The recapture——

Senator BUMPERS. For the benefit of some of you who may not know this, what the President is saying on the recapture issue is that if you made big investments in the past, for equipment we'll say, and you are taking advantage of the fast depreciation, you made these investments expecting to pay 46 percent rate of tax, the current rate. He's saying here you must continue to pay that rate and you are not entitled to both the fast writeoff of the investment tax credit and the new, lower tax rate of 33 percent. In other words, he's saying that you can't have it both ways. Now General Motors probably would be happy to give up the recapture provision in order to get their rate lowered from 46 to 33 percent. But, that's a raging debate in Congress and I'm interested to hear what you think about it.

Mr. LUDINGTON. In reading the bill, I understand that this is going to apply to approximately 150,000 people.

Senator BUMPERS. Incidentally it's a big revenue producer in this bill.

Mr. LUDINGTON. Since I didn't consider those 150,000—I more or less passed the issue. But, I don't think it's fair to come back and—one of our big problems today is planning. And how can you plan when they change the game rules and make them retroactive? That's a problem with this bill. It has a January first date on practically everything that is involved in it. And obviously Congress is not going to pass it before the end of the year. And how many of these items are going to be in there? Are they going to be in there when the bill is finally signed? So right now, you can't make any business decision because of this thing right here being up in the air. And I think it's wrong to go back and change the ground rules and that in reality is what they are doing.

Senator BUMPERS. Gaines, would you comment on that. You alluded earlier to the fact that Congress tinkered with the tax bill every year And it has. It's been tinkered with every year since I've been there. Of course this just drives business people up the wall because of what Sam says, the inability to plan. You can't plan anything with any degree of certainty. Would you comment on that recapture provision?

Mr. NORTON. It does mostly affect big businesses. I have one client who is particulrly affected, who in the seventies made enormous amounts of money because they were in an industry that's oil related and they expanded to meet what looked like their demand would be. Well, now, they are losing money like crazy. During the—they were still expanding during the early eighties and here they have put enormous amounts of money in expansion, in property and equipment and plants—by the way, which they are using right now at 50 percent capacity. They are getting no benefit right now out of the accelerated deductions. They did earlier admittedly. They are losing money, great amounts of money and right now they are going to have to pay taxes to recapture what they have already taken. It's going to be really burdensome for that industry. They didn't care what the tax law said when they made those investments. They were looking at increased production. But, now they are going to have to repay those taxes that never even entered their business decision.

Senator **Bumpers**. I really wish we had more time. I really enjoy talking to a couple of good accountants about this issue.

From the Floor. Senator Bumpers, may I ask you one question? I would like to know why a blue collar worker, single status, such as myself making $12,000 to $13,000 a year, by the time he gets his paycheck 33 percent of it is missing. There are some multimillionaires that don't lose a dime when tax time comes. I just want to know why.

Senator **Bumpers**. Well, I guess that's because our Tax Code permits it. That's a simple answer to your question. But, let me talk with you after this hearing is over, because this is a hearing of the Small Business Committee. The question you asked has a slightly different focus. I will be glad to talk to you about it as soon as the hearing is over.

Gaines, you and Sam both, thank you very much for excellent statements.

Our next witnesses are on a panel consisting of Victor Cary, president and CBO of Wortz—I always thought it was the Wortz Biscuit Co.—is it the Wortz Co. now?

Mr. **Cary**. The Wortz Co.

Senator **Bumpers**. And Sandy Sanders is manager of Government relations training for Whirlpool Corp. and has been with Whirlpool for 18 years. Is Ron Clarke here? Apparently he is not. Ron was supposed to be here. He is with the Merry-Go-Round Glass Co.

Victor, let's go ahead with your statement, please.

STATEMENT OF VICTOR CARY, THE WORTZ CO.

Mr. **Cary**. We, of course, have had an interest in small business operations for a long time. We may or may not be growing out of the definition of small business because for the last 10 or 12 years we have more than quadrupled our sales and earnings. We have, of course, I don't know if it's 20 million or not as the criteria for small business. But in any event, we consider ourselves small business. We consider ourselves poor. As I told all of my people when we started this business we were about to go out of business next week, and I want it run the same way today. I run it as if we were going to quit business next weekend. As far as expenditures are concerned, I heard many comments on business lunches and things, we don't bother with those things because we can't afford it. And if I ever spent $25 for a lunch, I'd go over to the sixth floor spot and have my head examined. But, that's another matter. As far as Government regulations are concerned, it's too much. We just don't answer the letters. I'm the mailman and we have one person who types and if anybody writes a letter and wants just casual information, that's too bad. They can call me up to talk to me, but there is just too much of that going on. The letters that you get from the Department of Agriculture, the Department of Labor, various committees of one kind or another, well, we just don't fool with them. We don't have the time.

Senator **Bumpers**. Do you ever get those letters where they are going to threaten to prosecute you if you don't fill out the forms?

Mr. **Cary**. Well, we don't—well, yes. We simply answer that the mail service is not always reliable. We will be glad to talk to you about it. We believe in all these things that people are trying to do, but, I've got to feel that people in Government, many of the agencies have a lot more people and a lot more time than we have. For example, you mentioned the Wortz Biscuit Co., we probably are the only food company that I know of in the past 12 years that prices have gone down and not gone up. All the towns around here, in fact all around the country because we distribute throughout the United States and then Alaska, and the price of our basic saltine which is 70 percent of our business has actually—12 years ago, it was 75 cents at the market, regular price 12 years ago. Now it's 69 cents. You try to run a successful business with prices down, you've got a problem, which brings me to the basic point. We can live with the tax bill. We like some things. We don't like some things. One of the things we like is the investment tax credit. The only way that we have been able to survive and make more increasing profits each year is to modernize, mechanize, cut people. And without investment tax credit it would be more difficult. But we can live with the whole thing. However, I recognize and I think that everyone does, especially you, and I'm out of my field talking about politics, but it's very controversial. Everything. Everybody's out to get the rich and to help the poor folks. Well, I identify with that, too, because I consider myself poor. But I'm not destitute.

Senator **Bumpers**. Those are relative terms right there.

Mr. **Cary**. Somehow—the fact the other day—I'm in every fund-gathering outfit or fundraising charity in town. Some of you are sitting around a table like this and someone says, "Let's hit old Joe up because he's a millionaire." I said, "Wait, a minute, hold it. Let's talk about that. Let's say old Joe's got a million dollars in cash, which I doubt. He's got it in money markets. He makes $80,000 this year. OK, well, by the time the Feds and the State are finished with him, he's back on food stamps." So what does it mean? You're right, it's a relevant term. All we try to do is to do the best we can. We work at it. We see it as a challenge. We see it as an important thing.

It is a very difficult thing to talk about, to go into the President's taxing. We all know it's going to change a thousand different ways before it comes up. So at Wortz Co., what we do, we base our decisions on economic justification. I don't worry whether the investment tax credit is going. I don't worry about whether the tax is going to be raised or lowered or some of these other aspects. We just plow on like we have been doing. We base our decisions basically on economic justification.

We are now planning expansion, right now, for a substantial sum which would mean a lot. Investment tax credit is very important. But that's not going to stop us. We're just going to keep going. Of course we like the tax reduction because we've been at max tax rate for a long time. We would obviously, as opposed to this young man somewhere who doesn't like that. We like the tax reduction. We can live with the other things that you have in the President's tax measure. All of them, one way or the other. But I think someone who—we've talked about that here before. The changes, the constant changes, the constant changes. You can't plan anything. You can't really operate. And the next thing you know someone's changed the rules and you're back to square one.

So we'd like to keep whatever is done. We can live with whatever is done. We will adjust to whatever is required. But what we would like is to make it as simple as possible with as few changes as possible. And that's about it as far as we're concerned. We're just going to press on and live with whatever comes out of it.

Senator **Bumpers**. Victor, that's an interesting statement and one that I wish every man in small business in the country could repeat in good conscience. I think that one of the reasons that we have such a problem with this is that Congress makes tax laws to direct an economic activity from a certain direction or maybe it is just an overall effort to generate economic activity, which sometimes is designed to help a particular industry and sometimes not. As Gaines and Sam both know, the Tax Code is just dotted with provisions that were put in there to help a particular industry or company. Oftentimes, it helps somebody that you didn't intend to help. But while you make tax laws for either political purposes or to increase economic activities in certain directions, you turn around and find you're not raising enough revenue to run the Government.

You mentioned the investment tax credit and yet, the two things in the tax proposal that the President has sent us, that probably raised the most money are, No. 1: The elimination of the deductibility of State and local taxes—that's worth almost $40 billion a year—and the second is the investment tax credit. Both are big ticket items from a revenue standpoint.

I have a problem with the ITC because the biggest contributor I have is president of Greyhound Leasing Co., the biggest leasing company in the world, and he's my brother. And his whole bottom line is dependent on the investment tax credit. So, you can see that I have a family problem with the investment tax credit, among other things.

But, I was a small business person for 18 years myself and I have to say that I very seldom made a decision based on tax questions. I didn't make enough money to worry about the tax consequences. I made decisions based on what I thought would be profitable for me and would help the business. And I think most small businessmen do that.

One of the principal reasons we have a Small Business Committee is that 80 percent of all the new jobs in this country are created by small businesses. And yet, so often, the tax laws are skewed in favor of big business. All I want to do is just keep the tax laws on an even playing field so small business people can be competitive.

[Subsequent information was received and follows:]

WORTZ
CRACKERS
& COOKIES

WORTZ COMPANY

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Senator Dale Bumpers
Senate Office Building
The Capitol
Washington, D. C.

9 September 1985

Dear Senator Bumpers:

Sorry to have missed the party in Fort Smith on Saturday. I was out of town.

Your hearing on Small Business here recently was interesting and informative. I have not seen the transcripts, but the SOUTHWEST TIMES RECORD article of 27 August and views expressed by some of my friends indicate that my testimony was unclear.

What I meant to say was - in a nutshell:

- On balance I favor the President's tax proposal.

- I do not like, in particular, cutting out the investment tax credit, which I think is very important to small business.

Again, thank you for allowing me to participate.

With all good wishes.

Sincerely,

Victor L. Cary
President

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United States Senate
COMMITTEE ON SMALL BUSINESS
WASHINGTON, DC 20510

September 13, 1985

Mr. Victor L. Cary
President
Wortz Company
P. O. Box 1059
Fort Smith, Arkansas 72902

Dear Victor:

Thanks for your thoughtful letter following up on our tax reform hearing in Fort Smith. I appreciate your taking time to clarify your position.

As a matter of fact, what you say now is exactly what I understood you to mean, but the press frequently misinterprets complex issues. In any event, your testimony was most enlightening and helpful.

I will see that your letter is included in the printed record of the hearing along with your testimony. As soon as the hearing is prepared, we will send you a copy.

Please stay in touch.

Sincerely,

Dale Bumpers

DB/jwbr

Senator BUMPERS. Sandy.

STATEMENT OF SANDY SANDERS, WHIRLPOOL CORP.

Mr. SANDERS. Thank you, Senator. My name is Sandy Sanders and I work for Whirlpool Corp., a manufacturer of major home appliances. We appreciate the invitation to present a statement today on the Federal tax reform, even though we are not a small business. Federal tax reform is a necessary step to achieve tax equity. Efforts to amend the Federal Tax Code are long overdue. However, in spite of this need, Whirlpool Corp. believes that a matter of even greater national urgency is the imperative to control the growing budget deficit and mounting national debt, and we are very aware of your position on this matter and appreciate it. Measures to balance the budget should come first from spending reductions before other avenues are considered. Solutions must be enacted quickly to dispel the economic cloud that is building over our national prosperity and quality of life. Only after a plan on deficit and spending cuts has been agreed upon should Congress and the administration take up the matter of tax reform.

Whirlpool has historically paid a large share of earnings to Federal taxes, with an average annual effective rate of about 45 percent since 1974. The company strongly supports tax reform measures that champion a fair-share taxation policy. We believe that all citizens, both individual and corporate, who benefit from Government services have an obligation to contribute a proportional share toward the taxes which funds the services rendered. It is our opinion that a modified flat tax approach, as outlined in President Reagan's plan, provides a useful starting point toward greater tax equity.

The administration's tax plan also proposes a minimum corporate tax. Its stated purpose is to assure that all corporations that receive Government services meet their responsibility to pay their fair share of the tax burden. We support that concept, but feel the plan as written will never fully achieve that goal. Although a minimum tax may increase the number of corporate taxpayers, the host of special interest tax shelters and preferences still preserved in the plan will cause it to fall far short of a fair share tax program.

Whirlpool endorses President Reagan's proposal to reduce the corporate maximum income tax rate from 46 to 33 percent, but has qualms about the weaknesses of the minimum corporate rate with all its tax preferences.

We seriously question whether the corporate minimum tax concept should be part of any fair-share tax reform measure since its continued presence gives tacit approval that certain tax preferences are acceptable. A more equitable approach would be a lower rate with no tax preferences.

We contend that one of the greatest stimulants for capital formation would be a lower effective tax rate. For example, the President's proposed reduction in the corporate rate from 46 to 33 percent even if the enactment of such proposal would mean changes in the Investment Tax Credit and the Accelerated Cost Recovery System. These were designed to stimulate capital investment and plant modernization, match more realistically cost recovery with capital expenditures, and encourage job creation. Overall, we believe the economic recovery now underway corroborates that Congress' goals are being met. In spite of their successes, the ITC and ACRS programs were add-ons to the Tax Code rather than the product of a deliberative, comprehensive tax policy for economic growth. Adoption of a new broad-based tax system like a reduced corporate maximum rate or flat tax plan would tend to provide a better long-term approach to address the needs of the emerging global competition. Equity in a corporate tax system will be better served by the flat tax approach which would broaden the base of corporate taxpayers, provide the required levels of tax revenues, while assuring needed capital formation for reinvestment.

The administration's proposal to tax past economic gains in depreciation dollars between the Economic Recovery Tax Act's scheduled allowances and straight line is objectionable. Its enactment would unjustly penalize businesses for having made previous investment decisions based upon then prevailing tax policy. We believe the administration should drop its proposal to tax past windfall gains.

Employee benefits should not be taxed. The President's plan would also change the tax treatment of a number of employee benefit programs. The three changes which we oppose are: First, lump sum pension distributions. Favorable tax treatment would be eliminated and early withdrawals would carry a penalty tax. Section 401K plans. Employer contributions for employees would be capped at a maximum rate of $8,000 to be reduced by any employee contribution to an IRA account. And finally, taxation of health plans. Employer-paid health contributions of $10 a month for individuals and $25 a month for families would be taxed to the employee.

Whirlpool employs approximately 22,000 people nationwide, and provides our employees a broad range of benefits that cost the company tens of millions of dollars annually. Our benefit package includes such things as group life, health and dental insurance, retirement pensions, savings and profit sharing, education tuition reimbursement, an employee stock ownership plan, disability and unemployment insurance plans, paid vacations and holidays and a host of other benefits. In most cases, these plans are extended at little or no cost to our employees.

Benefit programs like these make our employees more productive since they know they are protected not only against relatively minor interruptions to their employment—for example, short-term sicknesses—but against even catastrophic losses that threaten their families' well-being—for example, life and medical insurance.

Employer-provided benefit programs like Whirlpool's, over the long term, have reduced financial and social pressure on public sector programs like Medicare and Medicaid, Social Security, and many other publicly funded programs. Overall, employer-funded programs have been administered fairly, in a cost-efficient, prudent manner and, left untouched by Government, will continue to serve employees' and the Nation's needs in the future.

We believe it would be a grave mistake for Congress to target these programs for new taxes because it would debilitate one of the financially strongest private sector employee programs in existence. At a time when more and more Americans are asking for a more limited role for government, we should look to the private sector to assume a greater role. Congress should support, not discourage, that effort by continuing to grant favorable tax treatment of employee benefits.

We are very pleased to see that the tax exclusion for employer-provided educational assistance has been made permanent under the administration's proposal. This provision, which makes it possible for many employees to acquire new skills, is an investment in this country's productivity. It also demonstrates support and approval of the role of community and junior colleges, such as Westark Community College, play in the development of the skills and knowledge of our citizenry.

Over the years, shareholder dividends have been unfairly subjected to double taxation: once when included in the before-tax amount on earnings; then again as income to individual shareholders—except for minor exclusionary amounts.

The President's reform proposal would begin to remedy this discriminatory provision of the Tax Code by allowing a corporate deduction of 10 percent of dividends paid to shareholders. We endorse that provision as a first step, hopefully, to eventually eliminate virtually all double taxation of dividends and to rechannel these scarce financial resources into badly needed capital investments and jobs creation. Thank you, Senator.

Senator BUMPERS. Thank you, Sandy. Let me just take the last item that you mentioned there first. I think there's an alternative proposal. It might have been the Bradley-Gephardt bill, or it might have been the Treasury I proposal. Was that it, Chuck?

Mr. LUDLAM. Fifty percent was in Treasury I proposal and 10 percent——

Senator BUMPERS. Yeah, you could deduct—the corporation could deduct either 10 percent of the dividends that they paid out or 50 percent of their earnings. Was that it?

Mr. LUDLAM. The original Treasury I was to permit a deduction for 50 percent of the dividends, now they have cut it back.

Senator BUMPERS. They've cut it back to 10 percent, that's it. There are many people who think that there is a form of double taxation on dividends. Of course, I have used this argument myself because of my strong opposition to the elimination of the deductibility of State and local taxes, I have said that the President has always argued that by making people who receive dividends pay taxes on them after a corporation has already paid tax on its earnings is indeed double taxation. And I think that the President is right about that. By the same token, if you eliminate the deductibility of my State income tax, for example, I am not only paying State income tax on my salary but I am also having to pay the Federal Government taxes on the taxes that I've already paid the State. That's double taxation to me, too.

I think that it is just as a legitimate an argument in that case as it is on the case of dividends.

Second, just let me state my belief—and I think that I can say this with some degree of assurance—this bill will not tax fringe benefits. It certainly will not impose a tax on the employee for any portion of his health care program. I agree with you on this issue. Those health care programs take a tremendous burden off the Government in the form of Medicaid especially. As health care costs go up, obviously the cost of these health care plans go up too. To start taxing the employee for employer-provided health care, in my opinion, isn't going to happen.

While I don't think we have testimony on this point here this morning, in my opinion, there also will be no taxation of build-up of cash values on life insurance. Not only would that eliminate the life insurance business, that would just take away any incentive for people to buy life insurance. You can take the President's argument on taxing inside build-up and you can apply it to many other issues. For example, I bought a home in Washington 2 or 3 years after I went to the Senate and it's worth quite a bit more money now than it was when I bought it. It's appreciated in value, we'll say $3,000 a year. You could tax me on that increased value of my house every year under the same rationale as the President uses. So, taxing inside build-up probably won't happen.

Sandy, let me ask you about a minimum corporate tax. I have used your company as an example in a lot of speeches, not just in Arkansas, but all across the country, to argue that our tax laws are terribly askew. I have used the Whirlpool Co. as an illustration because you are in competition, for example, with General Electric. Don't misunderstand me, I'm not denigrating General Electric. Thye have simply taken advantage of the tax code as it exists. But in 1983, GE made $2 billion and because of that crazy Safe Harbor Leasing thing we put in that 1981 bill—which again, we repealed right after we realized what a miserable mistake it was—not only paid no income tax, but got a several hundred million dollar refund, because of its use of various tax preferences. Now, they are one of your big competitors in the household appliance business and Whirlpool—I forget what your profit was the same year—paid a very high effective tax rate. I have a tendency to be protective about Whirlpool because it is either the biggest or the second biggest manufacturing employer in the State. I want you to prosper and live a long time. But, I have said that is clearly unfair to Whirlpool to have to compete with GE, which not only pays no taxes but gets a refund while you are paying a high percentage of your profits in taxes.

So, is a minimum corporate tax, which would force companies like GE to pay some tax on substantial profits—an equitable proposal? Would it give you a little better competitive chance against them? I might point out that in 1984, 60 corporations in this country made billions of dollars in profits and paid no taxes and got billions of dollars in refunds. Now that may not all be bad, but there's something about that that really disturbs me.

Mr. **Sanders**. Of course, our position is that we will—we are in a business of competition. We face that competition. As far as paying our fair share of taxes, it's long been our corporate policy that we do believe as recipient of Federal Government services, it is our position that we will pay our proportionate share of it. As far as a minimum corporation tax, it will broaden the base of numbers of companies who will be providing additional tax moneys and we support that concept. But the only problem, or the only potential problem, comes in making that equitable, is the number of tax preferences still retained in the overall minimum corporate tax proposal. The concept of the minimum corporate tax itself is a good one and we very much support it.

Senator **Bumpers**. Certainly, every one of those corporations filed their taxes quite legally. We all try to reduce our tax burden as much as we can. It did. It did it quite legally. A minimum corporate tax is not as desirable to me as eliminating a lot of tax preferences would be. But I think that a minimum tax would be fair for everybody.

From the Floor. Do you feel that for individuals, too?

Senator **Bumpers**. A personal minimum tax?

From the Floor. Yes.

Senator **Bumpers**. That's a very good question and have had a tendency to favor that. However, also favor the exemption of interest on State and municipal bonds. The other day was talking on a talk show and the question you raise came up. We were talking about some kind of personal minimum tax. The question came up in this context: The Treasury Department had just released figures saying that 30,000 couples in the United States, taxpayers, 30,000 taxpayers made over $250,000 but paid less income tax than a middle-income family. was talking on this talk show and said that there's something seriously wrong with our Tax Code when people can make that much money and pay so little in income tax. A person called in with a very good question. didn't have a very good answer for him. He said if you believe in a minimum tax, but you also believe in the deductibility of interest on municipal bonds, you may be taking inconsistent positions. If somebody has $10 million invested in municipal bonds, he can have $1 million income and legitimately pay no taxes. This is why the minimum tax issue is not without its problems. That's the best answer can give you. It's not an easy question to answer.

From the Floor. I would tend to favor putting some kind of an alternate minimum tax on corporations where they would be just like individuals and have to pay something anyhow.

Senator **Bumpers**. You mentioned an alternative tax. Your point is a very good one.

Something that we have not talked about here this morning, Sandy, Victor, Gaines, and Sam, is the capital gains provisions. We have reduced the capitals gains tax rate. The President now has suggested that we tax certain income as ordinary income, rather than as capital gains. I can't subscribe to that for timber, for example, because the timber industry is so big in Arkansas. You can't entice somebody to go out and plant a tree and watch that tree grow for 40 years and then tell him that he is going to have to pay 40 or 50 percent tax on his income when he does harvest it at the end of 40 years. That just doesn't make any economic sense. You're not going to encourage people to plant the tree in the first place. Under the present proposals for capital gains the President wants to eliminate capital gains for timber. While I've always thought the capital gains exemption was skewed, I'm not prepared to eliminate it for timber.

Victor, you did say in your statement that you did favor the President's overall proposal, didn't you?

Mr. **Cary**. Yeah. I do favor it. Many parts yes and no, but, overall we'll take the President's proposal.

Senator **Bumpers**. Let me ask you this question. If you had a choice—this is a terrible burden to put on you to answer this question—but, if you had a choice between tax reform as such or balancing the Federal budget, which would you put the highest priority on?

Mr. **Cary**. Well, of course, you have asked a very difficult question. I have the contention that I don't know enough about it, or the Federal deficit which keeps growing and growing and growing. It's political dynamite, I understand that and I don't know enough about that. I think there are two simple things. We need to do something about them both. And we are beating around the bush on that. Personally, I think that we need to have a constitutional amendment because people, the Government is going to spend what they take in.

Senator **Bumpers**. They are doing very well in spending what they are taking in or we wouldn't need tax reform.

Mr. **Cary**. I asked a fellow once, he worked for a Government agency, I asked "Do you make money?" and he said "No, because we have to spend up to the limits of our budget."

Mr. **Sanders**. Our position on that subject would be that we would opt for the balanced budget.

Senator **Bumpers**. I'll give you an interesting figure. We have done an awful lot of cutting on the spending side, more I think than the public would believe. We have cut or held stable an awful lot of domestic spending programs, except for defense. Defense, of course, has increased about 100 percent in the last 5 years.

But, take these seven programs: Social Security, defense spending, civil service retirement, veteans programs, interest on the national debt, Medicaid, and Medicare. There are roughly 500 functions of Government and I've just named 7 of them. If you take those seven functions of Government in 1986 and you eliminated all the other 493 functions of Government, you would still have a multibillion-dollar deficit.

So, if you start talking about cutting spending, you can eliminate—not cut but eliminate—food stamps, every agricultural program, the Federal building in Fort Smith, AR, and Little Rock and every place else, the FBI, and every single program that you can think of, you'll still have a multibillion-dollar deficit.

It is said by the Congressional Budget Office which is a nonpartisan analysis think tank for the Congress and it is also said by the Joint Taxation Committee that the President's tax bill increases the deficit by 25 billion dollars over the next 5 years. Would you prefer to see that bill at least be revenue neutral, so that it did not——

Mr. **Cary**. No question about it. The reason that I prefer the new tax because from my company's standpoint, we save a great deal of money on the lower tax rates, no matter what happens, we save a great deal of money. So, from a pure selfish standpoint, but I understand it's a very highly controversial issue.

Senator **Bumpers**. Thank you both for fine statements.

Our next witnesses come from a banking and insurance panel. Bev Lambert is president of Merchants Bank here in Fort Smith and Joe Byars is president of BHC Life and Group Specialists here in Fort Smith.

Gentlemen, thank you both very much for being here. Bev, your name is first, so would you please start off.

STATEMENT OF BEVERLY LAMBERT III, MERCHANTS NATIONAL BANK OF FORT SMITH

Mr. **Lambert**. Thank you, Senator. My name is Beverly Lambert III, and I am president of Merchants National Bank of Fort Smith and currently serve as treasurer of the Arkansas Banker's Association.

I understand that the purpose of this hearing is to explore the impact of various tax reform proposals on small businesses. Therefore, I will briefly discuss two issues that could impact the financial community.

REPEAL OF THE RESERVE METHOD FOR BAD-DEBT DEDUCTION

Under current law, taxpayers may annually make a reasonable addition to a reserve for bad debts for estimated future losses. These taxpayers may deduct this annual amount instead of deducting losses for specific bad debts as they occur.

The President's proposal would repeal the bad-debt reserve method for taxable years beginning after 1985.

This is perhaps the most negative item in the bill for banking and the one that is the number one priority for the American Bankers Association. What this would do would be to put banks strictly on a net charge-off basis for loan losses. We would not be able to have any tax reserve.

In many areas that have been hit by problems in agriculture energy or other sectoral influences, they are probably operating on net charge-offs right now. The losses have been so heavy that the current methods for calculating it don't provide them much relief, and they are only able to deduct net charge-offs at the moment. The difficulties with this proposal are that it would insure that this would continue into the future, in addition to which you would have to take your current reserve back into income over the next 10 years. Current loss doesn't provide the correct deduction, so you aren't able to have your taxable income reflect your true income.

The repeal of the reserve method would tax businesses on income they have not received and when the present reserve balance is included in taxable income, even though it is spread over a 10 year period, businesses would likely pay taxes on income they will never receive. Compounding this problem is the difficulty of proving to the IRS when a debt does indeed become worthless. This seems inconsistent with the President's call for fairness.

This is an extemely negative proposal which affects all financial institutions, and it affects all other companies as well, because it means all our reserves would be eliminated entirely.

INTEREST EXPENSE TO CARRY TAX-EXEMPT BONDS

Second, the President is proposing that 100 percent of the interest allocable to purchasing or carrying tax-exempt obligations be eliminated. Allocation of this interest would be calculated in the same manner as for the 20 percent disallowance under present law. This burden really isn't aimed at banking, if you'll think it through, but aimed at cities, States, school boards, and local bonding authorities, because they are the ones who will pay the cost if we are no longer able to deduct it. This is an unfair rule. We should be able to continue to trade existing issues under existing laws.

Our tax consultant tells us that if our tax-exempt portfolio were put on a tax-equivalent basis, our effective tax rate would jump from 6 percent to 36 percent. A 30 point jump.

It needs to be understood that we, the banks, pay a tax no one else does in that we are required to keep sterile reserves at the Federal Reserve. The Fed turns over to the Treasury over $15 billion annually from money it earns on reserves. Our share, the bank's share, of this is $2 billion, and the last few years it's even approached $3 billion dollars. That's almost the same amount banks pay through income taxes. It is a very large figure. It is over and above what we have to pay our regulators. Chairman Paul Volcker has admitted in testimony before you in Congress that this is a tax that banks pay. Banks are not making a great profit from tax-exempt bonds and loans. We are making about the same profit on them that we make on our other loans. We ask that you not punish us for doing exactly what Congress has asked us to do—intermediate benefits to the State and the local governments.

CONCLUSION

Our lending group at my bank has told me that 75 percent of our commercial loans are to small businesses. Obviously, we champion small business and what it means to this country. As you navigate the complex passages of this process, we encourage you to emerge with a dynamic tax-reform bill which embraces the President's lofty goals of simplicity, economic growth and fairness. A robust, healthy small business America will be your reward.

Thank you for the opportunity to express these views on the President's tax reform proposal.

Senator **BUMPERS**. Bev, thank you very much. Joe.

STATEMENT OF JOE D. BYARS, BHC LIFE & GROUP SPECIALISTS, INC.

Mr. **BYARS**. Senator Bumpers, I want to thank you for the opportunity to discuss some of the issues with you today. I'd like to begin as you began your talk discussing the fact that Westark Junior College was the poor folks home in Sebastian County. That was news to me. Back in the year 1759 the first insurance company formed, and that was the corporation for relief of poor and distressed Presbyterian ministers and of the poor and distressed widows and children of Presbyterian ministers.

I think it's critical for us to recognize how this all began. It seemed that when one Presbyterian minister would die, all of the others were compelled to make a financial contribution for the support of his family. And, as time went by, for obviously many years, we discovered that the young people in the group became distraught when all these old dudes started dying. And they thought well, that's a good deal for the old folks to stay in, but we young ones ought to pull out, because you know every time you turned around one of these old coots was dying. So, they said what we really need is a rate structure for this arena whereby if you are young you pay X and if you're old you pay X times 2 or X times 3. So that we would make that benefit more equitable instead of treating all of the people equally as for as distributions made when would people die. And from that stemmed, through all these fancy actuaries, and all of this work that's done, the level premium concept when we are insuring in fact against the certainty of death, as opposed to the typical insurance product, which simply insures against a probability. You recognize that at age 99—when our mortality table tells us that everyone's going to die and there are few exceptions to that—they say that the only people that want to live to be a 100 are those folks that already are 99. They're all in a panic. Term insurance, which is temporary, costs in excess of $1,000 per thousand at age 99. And that's the reason that we must have level premium insurance, insuring you for the whole of your life, which simply means until the death date, and still not have to have premiums which become excessive when we reach old age. Now, early in the stages the insurance company kept that overcharge that they made to build up a reserve. They charged maybe $10 for $1's worth of insurance, so that ultimately they could be getting $10 worth of insurance for only $1. Someone said, "You know what we need to give that reserve that we're building back to the public, if for some unforeseen circumstance he has to leave the plan like the Presbyterian minister." And all of a sudden someone said, "Dang, that would make a helluva savings plan." And so, from that we began the concept of cash value life insurance. And to quote some more facts, I would like to say that the legislature of the State of New York in 1840 passed a law that said if a widow is named a beneficiary and the proceeds are made payable to her, not only are we exempt from taxes, but we are exempt from the claims of creditors. And this substantially increased the immeasurably protective power of what the business is that we perform from the standpoint of the life insurance industry. In 1861, Massachusetts was the first State to require that cash surrender values were a required part of life policies. It was established by law in 1880 in the State of Massachusetts for the same reason. When we talk about tax reform, which I am for—I recognize that we can't go on with the deficit spending—and I recognize that for middle Americans to bear the brunt of the blow from the standpoint of all the financial obligations that our country's had, I want legislators to focus on the difference between equal treatment and equitable treatment. For example, and this has nothing to do with the tax reform bill per se, did you know that if a 75 year old widow—excuse me, a 65 year old widow, had $1 million in the bank or as you expressed earlier, $1 million in tax exempt municipal bonds, paid no income taxes, that she's still entitled to her full social security check each and every month? Conversely, if because of imprudent planning, this widow were left with no life insurance and no assets and she had to scrub floors at Bev's bank in order to support her grandchild, perhaps, that was left homeless, that she could only earn X before she had a reduction of social security benefits. That I think very adequately describes the difference between equal and equitable treatment of our individual tax payer.

I think that every man, woman, and child, the sick, the old, and the indigent should pay at least $1 worth of income tax every year. I am personally not in favor of raising the zero bracket and exempting the masses from paying any tax. On the other hand, if a person, in excess of all their deductions, only has $1,000 left, has to pay $150, 15 percent of that in taxes, that's too much. I'd rather be in favor of a 2 percent minimum bracket, and let everyone take pride in contributing something without feeling a financial burden—contributing something from the standpoint of generating the Federal income taxes. From the standpoint of tax reform, I feel that we have had a great deal of attack as it affects the small business man on the insurance industry, not withstanding just the life insurance industry. And I will readily admit that there have been some abuses in the life insurance industry from the standpoint of converting some of our products to investment shams as opposed to the original intent that it had. And I think that that should be corrected. But, certainly not by taxing the cash values in life insurance policies. If you want to ask any small business man what his major problem is today, I'm talking about today, it's probably the rate increase that he just received on his property and casualty insurance.

Senator **Bumpers**. I want you to know that I am getting a lot of mail about that, Joe. I don't know what I can do about it, but insurance rates are going up till it's almost prohibitive.

Mr. **Byars**. Now, I'm not here to actually debate the necessity of having to raise those rates. If we look at financial troubles that some of the major property and casualty insurers are faced with today...

Senator **Bumpers**. They are getting in trouble.

Mr. **Byars**. They are getting in trouble, which is going to mean everybody else's rate is going to go up more. Small business men can't afford to pay it. And so now then we are going to go in and burden it even more with tax reform that's got to adversely affect them from the standpoint of their reserve when they take the tax cut. Which brings up a point. Talk about deferred annuities and back in 1977, I think we saw when the people talked everybody listened and what really came to be just really investment shoppers and we made some very corrective changes in that with taxes when we took away the LIFO and FIFO treatment with some of the premiums on annuities. The government is ultimately going to get all the money on that tax deferral and on all those goodies. It's ultimately going to be a windfall to the Government when they surrender those annuity contracts at a later date. So, this is really not the same type of investment scheme, as perhaps the tax-exempt municipal bond. But, like you, I don't favor that. I feel that in the final analysis that we need to be very careful with tax reform and I think that it appears to me that everyone seems we're going to deal with haste. And it is too critical to our economy to attack this in a hasty fashion. We've made improvements and enhancements in the rider, ad hoc fashion or probably since 1960's and I think that if we are going to do a total overall reform, like we are talking about now, that we are acting with too much haste without recognizing the adverse effect that it would have on a small business man is a fact all over the country. I'd be in favor, for example, of a bill that might say, "Joe, you could only deduct 90 percent of the interest on your home loan. Ninety percent of the interest on the money that you might have borrowed to put your corporation together 4 years ago. You can only deduct 90 percent of your charitable contributions. Ninety percent of depreciation or gas expense on your car. And we don't deal with $25 lunches, we deal with $2.50 lunches here in Fort Smith. So, I wouldn't care if they only let me deduct only 90 percent of that $2.50 lunch, as long as we focus on an equitable treatment and eliminate corporations like General Electric not having to pay any tax at all. I feel that corporations as well as individuals should pay their fair share of the tax.

Senator **Bumpers**. Joe, thank you very much. It's a most interesting statement.

[The prepared statement of Mr. Byars follows:]

B·H·C
Life & Group Specialists, Inc.
5424 EUPER LANE • P.O. BOX 3529 • FORT SMITH, ARKANSAS 72913-3529 • (501) 452-4000
Joe D. Byars, C.L.U.
President

STATEMENT OF

Joe D. Byars, CLU ChFC
Life Insurance Broker

Before: Senator Dale Bumpers, the U.S. Senate Small Business Committee

Subject: The President's Tax Reform Proposals

Date: August 27, 1985

My name is Joe Byars and I am pleased to have this opportunity to express my opinions on the President's Tax Reform Proposal and its impact on small businesses. The proposed bill would have a dramatic impact on the insurance buying public which certainly includes most tax paying Americans. The severity of the impact on insurance agents, as small businessmen and women, is even more dramatic but we are here to stay!

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61

I am in favor of Tax Reform. I am in favor of a balanced Federal Budget and recognize the adversities of continued deficit spending. It is unfair for middle Americans to carry the burden of supporting the vast majority of our great country's obligation.

It is absurd to believe we are being fair when hundreds of wealthy individuals actually pay no income taxes. I also believe that every American citizen should have to pay at least one dollar in income taxes. Every man, woman, and child should pay something. The sick, the old, and the indigenous should take pride in paying at least one dollar to support our great country.

Americans don't want to be treated EQUALLY when taxes are imposed. EQUITABLE treatment was the obvious intent when progressive taxes were first legislated. It is therefore, imperative for EQUITABLE treatment to be the focal point of tax reform.

The life & health agents in this country receive intangible income as they recognize the socially beneficial aspects of providing income to widows and orphans. Relief from financial ruin due to sickness or injury can be adequately served by the insurance products we sell. History reveals that our industry felt threatened by government intervention on at least two occasions.

Most recently, you will recall the thoughts of National Health Care. The Kennedy Bill, and others, suggested that "Medicare for everybody" was the solution to inflationary trends in the cost of health care. Our industry, and the medical profession, are no longer having to lobby against this absurdity.

The advent and enhancements of Social Security were once perceived as a threat to the necessities of family life insurance. We now recognize the fact that government cannot afford to provide adequate support for families left without earnings due to death, old age, and disability. The life insurance industry is the only industry which can create an instant estate at death, provide paycheck insurance for disability, and medical insurance to relieve the financial burdens of medical treatment.

Approximately three fourths of new life insurance protection purchased in the United States last year was bought on an indiv--idual basis. That is, by personal or family decision--usually through a life insurance agent. In 1983 Americans purchased $1,026.4 billion of new life insurance ($1,026,400,000,000). Group life insurance accounted for less than 25% of this total. The average face amount purchased in 1983 was less than $45,000! Are we serious when we suspect that the majority of people buy their life insurance to dodge taxes?

However, I am told that 85% of working Americans were not asked to purchase life insurance last year unless they were asked on the job through a payroll deduction plan.

It would be prudent for all lawmakers to study the "Life Insurance Fact Book" published by the American Council of Life Insurance. You would discover that the average life insurance owned is only $54,200 per family. You would also be able to recognize the positive impact of life insurance company investments on the overall U.S. economy.

Specific aspects of the President's Tax Reform Proposal should be addressed as they relate to the insurance industry. The most significant is the "inside build up taxation".

Inside Build Up

If one purchased raw land which appreciated in value, should he pay taxes on the gain before the sale? What about gold, silver, common stock, art works, antique automobiles, apartment and office buildings, and more importantly, homes?

Word was mentioned that parity with other financial institutions was a concern. The encouragement of thrift should be a motive of Tax Reform. Americans are not saving an adequate portion of their disposable income. There has been adequate testimony concerning banks in the insurance industry. Conflicts of interest and the obvious turmoil surrounding insolvency problems dictate intervention to keep banks out of the insurance industry. Banks could be allowed to market deferred retirement accounts similar to flexible premium and single premiums annuities. However, settlement options involving life expectancy should be excluded. FDIC insurance on such accounts would give the banks a competitive edge which wouldn't be fair.

Policy loans should not be taxed since we don't treat any other source of borrowed funds as income. Is it feasible to consider making automobile and other consumer financing taxable?

Lawmakers need to recognize the reason cash value policies were invented---Death is a CERTAINTY. Other forms of insurance are based on a PROBABILITY. Therefore it is essential for rates to be higher than required at young ages if a level premium for life is desired. This allows the companies to reserve for years in later life when the level premium charged is less than adequate for the cost of risk. The cash surrender values were an indirect result of the reserves so established...A "refund", if you will, of the excess premiums charged in early years. Term insurance costs are more than $1,000 per $1,000 at age 99 when death is presumed a certainty!

TAXATION OF CERTAIN FRINGE BENEFITS

Should the tax reform discourage employer provided fringe benefits?

Qualified pension and profit-sharing plans have already been stricken with red-tape and administrative burdens. Many small businesses had to cancel their retirement plans due to this intervention. Was it socially beneficial to working America for thousands of plans to be cancelled?

Group medical insurance provided by employers has saved our country from forced Socialized medicine. I think that is great! Health insurance premiums should be deductible by all tax-payers. This is a more equitable government subsidy than any other method.

ALTERNATE SOLUTIONS

A) Allow a percentage deduction for all deductible items. I have used an arbitrary 90% figure. e.g.

90% of all interest is deductible from income (Both Business and Personal)

90% of all charitable contributions

90% of all currently deductible fringe benefits

90% of all depreciation

90% of all depletion allowances

90% of all business travel and entertainment currently allowable

90% of business rent

90% of state and local taxes

Allow 90% of the normal investment tax credits

Reduce capital gains treatment to 90% of the current 60% tax-free gain.

Allow a 10% deduction for corporate dividends paid

Allow a 10% exclusion on all interest & dividend earnings

Exempt 90% of municipal bond income (inlieu of 100%)

Increase the alternate minimum tax on preference items

B) Lower the minimum tax bracket to 2% and lower the zero bracket amounts. This will increase the number of tax-payers without real burden to them.

C) Raise the corporate tax rates for incomes in excess of $250,000-$500,000 and $1,000,000. Keep corporate rates between $100,000 and $250,000 as they are.

D) Lower the tax bracket for individuals earning less than 4 times the mean average disposable personal income per family (1983-$25,000). Keep brackets the same for families earning 4 to 6 times the disposable income average and raise them for amounts over that level.

In closing, I'd like to reinforce the importance of equitable treatment for all tax-payers.

Measures which are contrary to the public attempting to protect families, employees, and businesses are not in the best interests of this country. The taxation of the inside build up would be an administrative blunder which would increase the costs of self protection. We should encourage employers and individuals to provide adequate life and health insurance. Incentives to purchase permanent life insurance in lieu of temporary term policies should not be hindered.

Senator **Bumpers**. Bev, I might point out that one thing people don't think much about is the fact that banks are required to keep a percentage of their deposits on reserve at the Federal Reserve Bank. And the Federal Reserve Bank makes an awful lot of money off that reserve account. This requirement is, in effect, a tax on the banks, though it's not recognized as a tax. I think, Gaines the bank's argument on taxes is very similar to the one made by contractors. You know the Treasury I, I believe, proposed to put contractors—make contractors pay taxes on their profits as they went along instead of when they completed the project. That never did make any sense to me because when I practiced law in Charleston I used to represent a lot of contractors. John McConnell here in Ft. Smith was one of my biggest clients and John never knew whether he was going to make a dime or not until the contract was finished. To tax somebody before the job was completed seemed patently unfair. I think taxing people on losses that they may or may not sustain is what Bev is saying here. To tax them on money that they may never receive would really be patently unfair.

So, I think the banks have a very good argument. I'll just make one other observation. You were talking about the young people back in the old days getting upset about all of these old Presbyterian preachers dying. Of course, I'm a Democrat and we're still kind of on the endangered species list. Not the least of the reasons is that the 25 to 40 white male age group has left the Democratic Party in great numbers. I believe that one of the biggest reasons for that is that most of them feel that while they are paying a tremendous amount for Social Security, they fear it won't be there when they are 65 and eligible to draw. I really think that my party has the responsibility to convince them otherwise, not just on that but on some other things that are concerns to small, upwardly mobile, young business people. I understand why they feel that way. I thank both of you for very good, interesting, informative, educational statements. Thank you for taking off the time to be with us.

Our last two witnesses are from the cattle and timber industry, which are affected very dramatically by this tax bill. John Porter Price is with J.P. Price Lumber Co. in Monticello. Ned Ray Purtle is the owner and manager of Ned Ray Purtle & Son of Hope, AR, and is a fifth-generation cattleman. John Porter, your name is on here first, so if you would start it off.

STATEMENT OF JOHN PORTER PRICE, J. P. PRICE LUMBER CO.

Mr. **Price**. Thank you, Senator Bumpers, and members of the committee, for providing a forum on this vital issue. I am John Porter Price. I live in Monticello, which is located in southeast Arkansas. I am president of J. P. Price Lumber Co. This company is involved in the manufacture of various forest products. Our company employs 100 people directly and approximately 400 people indirectly in the form of loggers and procurement people. I am on the board of directors of the Arkansas Forestry Association and on the Hardwood Manufacturing Association, also a board member of a small bank and also a member of the Drew County Quorum Court.

I went in business 20 years ago and I've seen the lumber business cycle both up and down many times since I started. But, Senator Bumpers, the timber industry is facing the most bleak business outlook and future that I have ever seen. I am convinced that the decisions that our lawmakers make in the next few months concerning our economy will affect our economic future for years to come.

I want to talk to you this morning as a small businessman, which I am. I am not an accountant, I am not a lawyer, and I am not by any stretch of the imagination a tax specialist. I am a small businessman who is trying to survive in the forest products industry today. Let me describe what I think a small Arkansas forest products manufacturer is. He is a small businessman who raises enough capital to build some sort of wood processing plant. He could be a sawmiller, or a post plant operator, or a pallet manufacturer, or a handle manufacturer or run a picture frame plant. But they all have similarities. Hardly any of these companies own any timberland. They rely on small timberland owners to grow the timber for them. Each makes a special product that he markets to some particular segment of the marketplace. Each of these companies has one common denominator concerning his products and that is he must sell his off fall, some people call it waste, to the paper companies in the form of wood chips or fuel. He must have markets for these products in order to be profitable. The point is, the small timber operator is dependent upon the paper companies for a market for this product. Paper mills cost millions, maybe even billions of dollars, to build. We have basically six companies—Georgia Pacific, International Paper, Weyerhaeuser, Potlatch, Nekoosa, and Arkansas Kraft. As a small forest products company, it is extremely important that these large paper companies are able to compete in the world market, survive and be profitable because if they can't survive, we surely can't survive. We here, as a small businessman, we are allies with the larger business from the standpoint that we need him to be profitable in order for us to be able to compete ourselves.

The President's proposed tax bill will affect the small businessman in many ways. I would like to discuss the two areas that I feel will be the most detrimental to us as a small timber company. First the tax could eliminate our future timber supply. You alluded to this awhile ago. Second, it will greatly effect our ability to sell our byproducts, which is an absolute necessity.

Let me discuss our future timber supply. Price Lumber Co. owns less than 1,000 acres of timberland. Each year, we harvest in excess of 10,000 acres. So, you can see that we are dependent almost entirely upon outside sources for raw materials. I would venture to say that 99 percent of the small forest products companies in Arkansas are in the same boat that we are in. The tree farmer and the small wood lot owner must grow our timber for us. Even with today's tax structure, the small timber grower has few economic incentives to grow timber. It's hard to convince a person to practice good forestry or forest regeneration and have to wait 25 to 40 years to get a return that is not guaranteed. With the President's proposed tax bill, the tax incentives are greatly reduced and eliminated in most areas. He is much wiser to put his money in CD's or

Treasury Bills, to name a few. Treasury II is the most serious attack on fair timber taxation since I have been in the forest products business. Good forestry and timber regeneration will be penalized. Poor management, or no management will be encouraged. The proposals will stifle timber growing and employment, will reduce community stability. You ought to go to Hermitage, AR, today. It would have serious price effects and would return Arkansas and the Nation to an early time of underinvestment in timber growing. Senator, small companies such as Price Lumber Co., cannot survive, cannot continue to grow, unless the small timberland owner has tax incentives to grow timber.

Now let me discuss our future and how it's connected with a strong paper market. As I stated earlier, our ability to be profitable depends greatly on our ability to sell our wood chips and fuel to the paper industry. For the last 5 years, if we had no sales for our byproduct, we would have been broke now. Anything that is done that hurts the large paper companies flows down and deals directly to the small timber operations, but even a harder blow. The elimination and productionm costs are such measures. The elimination of investment credit will be the final straw that will stop all new construction and any reworking of existing mills. This will mean a severe reduction in jobs.

As I left my mill this morning, over half of our operation is down. This is due to the fact that International Paper Co. at Pine Bluff has shut its paper mill down. This is the second time this year that it's been down cold. The reason it is down is that they have no orders. A lot of this is because of foreign competition, to name a few. But, they have under construction right now, a $200 million expansion. This hopefully will help us to be able to compete with foreign competition. But with the President's tax bill, I question whether I.P. will continue making such investments. We need the paper mill in operation; without them the small operators cannot survive.

For your information, the Arkansas Forestry Association executive meeting announed its opposition to the Reagan administration's current tax plan in its entirety because of the severe and detrimental financial effect it has on the industry. Many believe it would lead to deindustrialization of the Nation—something we certainly don't need at this time.

I dropped something a while ago. What I was wanting to say——

Senator **Bumpers**. If it was money, I'll sweep the floor.

Mr. **Price**. We are caught in a catch-22. I believe that we need a tax reform. I happen to—Mr. Cary made a statement awhile ago—a dear friend of mine who is deceased now, an older fellow, he used to tell me, he said, "John, don't worry about paying taxes," he said, "you get out there and you make your decisons based on economic conditions, whether you can make money or not". If the small timberland owner--and I agree, that's what we do—we try to make a dollar and then we worry about paying the taxes. But if the small timber operator uses that rationale and I think everybody agrees here, he'd be a fool to raise timber. The Nation will be poor for the fact. We're caught in a catch-22, the President's tax bill in a net effect is supposed to help the individual. We have a statement here from a large accounting firm that it will save the individual $131 billion. The net effect to corporations is going to hurt him $118 billion. But, the only net result is it would only generate $13 billion more money. But, we as a small timberland owner, we are double hurt because the individual who is supposed to be helped it's going to hurt him from the exclusion of capital gains, when you start reducing that. And it's also going to hurt him when you repeal investment tax credit. So, that's going to stop him, the individual, from raising timber. And the same effect, it's going to hurt us from the corporation standpoint because they most surely have most of their incentives taken away from them to reinvest in equipment and try to meet this foreign competition and competition as it stands today. So that's—you asked the question of how I feel about the tax bill as it is—if I had to say the way it is now or the way it is proposed, I would have to say we want it like it is right now. But, I think that, I know we need it—we need to be changing—but, we must, from a small timber operator, we must consider that if it would pass like it is today it will—it kills our future, Thank you.

Senator BUMPERS. Thank you, John Porter. Ned Ray.

STATEMENT OF NED RAY PURTLE, NED PURTLE & SON

Mr. PURTLE. Senator. My name is Ned Ray Purtle. I am a rancher from Hope, AR. I am presently serving as chairman of the Public Affairs Committee of the Arkansas Cattlemens's Association and as president of the Hempstead County Farm Bureau. Neither of these organizations at this time have a policy developed on the proposed tax reform bills, simply because that they have—in their process—they do it in annual meetings and their membeships determime that. So the remarks that I will make today are my own observation. However, I do feel that they represent the vast majority and they will be the unofficial policy of these organizations.

My ranches are located in Hempstead and Nevada counties down in southwest Arkansas. And as the Senator said earlier, I am a fifth generation cattleman. I have two sons who—and there is some serious doubt as to whether they are going to want to continue the business. The cattle business is my only business and has been all of my adult life. As you know, agricultrue and the cattle business are currently undergoing some very difficult and trying economic times. As cattlemen and businessmen, we recognize the importance of a fair and equitable tax code which promotes growth and good economic business decisions.

Fairness is the key to tax reform and must govern changes in the Tax Code. The cattlemen of Arkansas will readily accept and desire changes which will make the tax law fairer and are aimed at treating all industries and individuals equitably. Fairness should be the No. 1 goal of Congress.

I would urge that no particular industry be singled out for a specific change treating a perceived symptom. For example, changes which try to limit deductibility of farm losses without regard for the source of the loss are nearsighted and do not address the provisions in our tax code that underlie the problem. Now, I feel that there are some favorable provisions in the tax reform, one of them of course the lower marginal tax in business government. We would all like to see that from the taxpayers' standpoint. But in the cattle business, I think an economic incentive of the desirable results—the lower marginal tax rate will reduce the incentive from taxpayers to seek out tax shelters and stimulate cattlemen to make decisions based on economic rationale and not based on tax considerations alone. I think that is one problem—one thing that would be in the long haul and certainly advantageous to the cattle industry.

President Reagan's proposed Capital Cost Recovery System, in deference to what our CPA friend said, does fairly reflect a useful life and reasonable economic depreciation. In addition, the proposed CCRS accurately reflects the true depreciation value by indexing for inflation.

Income averaging is another issue that is of great importance to cattle producers of Arkansas and the Nation. The cattle business is a highly volatile industry. Net income from farming and ranching can fluctuate as much as 100 percent or more from year to year. The lower marginal tax rates will offset some of this, but not all of it by the impact of repealing income averaging.

There are some unacceptable provisions in the proposed tax reform. The one that really affects the cattlemen of Arkansas because essentially most of us are cow/calf operators, is this provision of multiperiod expensing. The President's proposal requires all expenses (other than interest and taxes associated with the production of replacement heifers) to be capitalized if the preproductive period exceeds two years. Well, the 2-year period begins when the heifer is conceived and ends when she is placed in the breeding herd. Cattlemen normally place the heifers back in the herd at 15 to 18 months of age, so when you consider the 9-month gestation period, essentially all farmers and ranchers will be required to capitalize expenses. This produces an accounting nightmare for cattlemen, and literally forces them to switch to some sort of hybrid accrual method of accounting.

In addition, cattlemen could be forced to make a noneconomic decision, either capitalize expenses on raised replacement heifers or purchase heifers to avoid capitalization. This places an unreasonable burden on cow/calf producers and violates the objective of fairness in tax reform. It is oncongruous that a tax reform proposal would encourage an uneconomic decision to purchase breeding cattle to avoid the accounting nightmare.

The capital gains aspect that you alluded to before, Arkansas cattlemen would oppose the elimination of capital gains treatment for section 1231, assets which include breeding livestock. Elimination of capital gains tax treatment on income from the sale of breeding livestock doubles the burden on the cow/calf producer. A cow, which is held as a capital asset to produce calves as ordinary income, is similar to a factory and should be eligible for the capital gains treatment. Congress has long recognized a distinction for public assets, such as breeding livestock, as opposed to business property held for sale. We feel our industry was unfairly targeted in the President's plan.

Another area of concern is soil and water conservation, the immediate deductibility of soil and water conservation costs. As stewards of the land, farmers and ranchers must continually practice soil and water conservation measures to maintain their production base.

All soil and water conservation improvements are not the same. For example, fertilization, brush control, and seeding of waterways are recurring expenses with little carryover and should be expensed.

Improvements that are not permanent to the land should either be currently deductible or depreciated over a relatively short period. The President's plan would require the expenditures be added to the basis of the land; consequently, a farmer who builds a stock pond that lasts 15 years before it fills with sediment, must build another pond. Under the President's proposal, the costs associated with building that first pond would not be depreciable; instead, these costs would be capitalized into the basis of the property.

Another item was cash accounting. Most farmers currently use the cash method of accounting in their operations. The ability to deduct expenses as incurred and account for income as it is actually received serves as important and useful management tool for cattlemen. Fluctuation in prices, weather, interest rates and other factors create cycles of farm income and farm losses that are moderated under cash accounting.

The President's proposal places a limit on the availability of cash accounting to those farmers and ranchers whose operations create less than $5 million in gross receipts. We feel this is an arbitrary level that fails to consider the type of farming operation and makes no distinction or reference to livestock versus crops or permanent versus annual crops. We urge Congress to remove such an arbitrary cap and to permit farmers and ranchers to continue using the cash method of accounting if they choose. Congress should not dictate a method of accounting and avoid drafting such provisions that have little relation to the nature of a particular business.

I would like to point out in summary at this time that the average cow herd in Arkansas is 26 head and this figure pretty well represents the cow herd size across the Nation. The largest State I think is perhaps Wyoming with 40 head and even Texas is less than 35 head. So, this tells us that there are very few of us that make a living out of the cattle business. However, it also says to me that over 90 percent of 40,000 cattle owners in Arkansas, who live in the country, work in town, have businesses in town, use the income from their cattle as a supplement to their total farm income. We have seen the number of cattle owners in Arkansas decline from over 50,000 in the last decade. If some of the proposed changes in the tax reform bill, like the multiperiod expensing, the loss of capital gains and the cash accounting procedures are implemented into law there will certainly be a larger reduction of cow herd owners across the country.

Senator Bumpers, I recognize the difficult deliberation that confronts you as you attempt to reform the Tax Code to make it fair, simple and yet maintain incentive for growth. However, cattlemen encourage you not to lose sight of a very worthwhile and desirable goal. Thank you.

[The prepared statement of Mr. Purtle follows:]

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Testimony on Tax Reform

before
U.S. Senate Small Business Committee
Field Hearing, Fort Smith, Arkansas

Submitted by
Ned Ray Purtle, Rancher
Hope, Arkansas

August 27, 1985

Mr. Chairman and members of the Committee, my name is Ned Ray Purtle. I am a rancher from Hope, Arkansas. I am presently serving as Chairman of the Public Affairs Committee of the Arkansas Cattlemen's Association and as President of the Hempstead County Farm Bureau. Neither of these organizations have adopted a position on these Tax Reform proposals simply because their policy-making decisions are made by their memberships at their annual meetings. These meetings will not be held until later on this year and January of 1986. The remarks that I will make today are my own observations; however, I am sure that they will express the thinking of the vast majority of the cattle producers in the state of Arkansas.

My ranches are located in Hempstead and Nevada counties in Southwest Arkansas. I am a fifth generation cattleman and the cattle business is my only business. As you know, agriculture and the cattle business are currently undergoing some very difficult and trying economic times. As cattlemen and businessmen, we recognize the importance of a fair and equitable tax code which promotes growth and good economic business decisions.

Fairness is the "key" to tax reform and must govern changes in the tax code. The cattlemen of Arkansas will readily accept and desire changes which will make the tax laws fairer and are aimed at treating all industries and individuals equitably. Fairness should be the number one goal of Congress.

I would urge that no particular industry be singled out for a specific change treating a perceived sympton. For example, changes which try to limit deductibility of farm losses without regard for the source of the loss are nearsighted and do not address the provisions in our tax code that underlie the problem.

FAVORABLE REFORM PROVISIONS

Lower marginal tax rates create an economic incentive and are a desirable result of tax reform. I would think that lower marginal rates will reduce the incentive for taxpayers to seek out tax shelters and stimulate cattlemen to make decisions based on economic rationale and not based on tax considerations alone.

President Reagan's proposed Capital Cost Recovery System appears to fairly reflect useful life and reasonable economic depreciation. In addition, the proposed CCRS accurately reflects the true depreciation value by indexing for inflation.

Income Averaging is another issue that is of great importance to the cattle producers of Arkansas and the nation. The cattle business is a highly volatile industry. Net income from farming and ranching can fluctuate 100% from year to year. Lower marginal tax rates will offset some, but not all of the impact of repealing income averaging.

UNACCEPTABLE REFORM PROVISIONS

Several areas of the various tax reform proposals are cause for substantial concern in the cattle industry. I realize the need to lay these concerns on the table and will do so today. Some of our problems with the President's proposal can be rectified with minor technical changes and others will require modifications based on fairness. I feel it is important to outline our concerns today and then to work with you, the Ways & Means Committee, the Administration, and other agricultural organizations to achieve a fair and equitable tax bill.

MULTIPERIOD EXPENSING

At the top of our list is a concern over a provision in the Administration's proposal on preproductive period expenses. The President's proposal requires all expenses (other than interest and taxes) associated with the production of replacement heifers to be capitalized if the preproductive period exceeds two years. The two-year period begins when the heifer is conceived and ends when she is placed in the breeding herd. Cattlemen normally place the heifers back in the herd at fifteen to eighteen months of age, so when you consider the nine-month gestation period, essentially all farmers and ranchers will be required to capitalize expenses. This produces an accounting nightmare for cattlemen, and literally forces them to switch to some sort of hybrid accrual method of accounting.

In addition, cattlemen could be forced to make a noneconomic decision, either capitalize expenses on raised replacement heifers or purchase heifers to avoid capitalization. This places an unreasonable burden on cow/calf producers and violates the objective of fairness in tax reform. It is incongruous that a tax reform proposal would encourage an uneconomic decision to purchase breeding cattle to avoid the accounting nightmare.

CAPITAL GAINS

Arkansas cattlemen would oppose the elimination of capital gains treatment for Section 1231, assets which includes breeding livestock. Elimination of capital gains tax treatment on income from the sale of breeding livestock doubles the burden on the cow/calf producer. A cow, which is held as a capital asset to produce calves as ordinary income, is similar to a factory and should be eligible for capital gains treatment. Congress has long recognized a distinction for capital assets, such as breeding livestock, as opposed to business property held for sale. We feel our industry was unfairly targeted in the President's plan.

SOIL AND WATER CONSERVATION

Another area of concern to cattlemen is the elimination of immediate deductibility of soil and water conservation costs. As stewards of the land, farmers and ranchers must continually practice soil and water conservation measures to maintain their production base.

All soil and water conservation improvements are not the same. For example, fertilization, brush control, and seeding of waterways are recurring expenses with little carryover and should be expensed.

Improvements that are not permanent to the land should either be currently deductible or depreciated over a relatively short period. The President's plan would require the expenditures be added to the basis of the land; consequently, a farmer who builds a stock pond that lasts fifteen years before it fills with sediment, must build another pond. Under the President's proposal, the costs associated with building that first pond would not be depreciable; instead, these costs would be capitalized into the basis of the property.

CASH ACCOUNTING

Most farmers currently use the cash method of accounting in their operations. The ability to deduct expenses as incurred and account for income as it is actually received serves as important and useful management tool for cattlemen. Fluctuation in prices, weather, interest rates and other factors create cycles of farm income and farm losses that are moderated under cash accounting.

The President's proposal places a limit on the availability of cash accounting to those farmers and ranchers whose operations create less than $5 million in gross receipts. We feel this is an arbitrary level that fails to consider the type of farming operation and makes no distinction or reference to livestock versus crops or permanent versus annual crops. We urge Congress to remove such an arbitrary cap and to permit farmers and ranchers to continue using the cash method of accounting if they choose. Congress should not dictate a method of accounting and avoid drafting such provisions that have little relation to the nature of a particular business.

SUMMARY

I would like to point out at this time that the average cow herd size in Arkansas is 26 head and this figure pretty well represents the cow herd size nationwide. This tells us that there are not very many of us that make our living from the cattle business; however, it also tells us that probably over 90% of the over 40,000 cattle owners in Arkansas, live in the country, work in our towns and use the income from their cattle as a supplement to their total family income. We have seen the numbers of cattle owners in Arkansas decline from over 50,000 in the last decade. If some of the proposed changes like Multiperiod Expensing, loss of Capital Gain provisions and Cash Accounting procedures are implemented into law there will certainly be a much larger reduction in cow herd owners across the country.

Senator Bumpers, and members of the Committee, I recognize the difficult deliberation that confront you as you attempt to reform the tax code to make it fair, simple and yet maintain incentive for growth. However, cattlemen encourage you not to lose sight of a very worthwhile and desirable goal.

Thank you very much for the opportunity to appear at this hearing and for your consideration to these most important issues.

Senator Bumpers. You know, one of the very best things that ever happened to me about joining politics was that I had to sell my cattle to raise the money to run. I saved myself no telling how much money by selling that herd 16 years ago. Now, if I'd have gotten beat I probably wouldn't have felt that way.

Cattle farmers, you know, you really preach to the choir on that one, because they are really in tough shape. With no changes in the tax law, they are in big trouble. For the first time you are seeing dairy farmers as well as cattle farmers getting in trouble. Dairy farmers have been reasonably prosperous for the past several years. Now dairy farmers and cattle farmers are all getting in very serious trouble. Incidentally, I didn't realize that the President had proposed a change in taxation of soil and water conservation practices. My guess is that anything that would have any adverse impact on any segment of agriculture will never see the light of day in this tax bill because they are an endangered portion of the economy.

From time to time, we have had proposals in the Senate to prohibit charging off losses by farmers when their principal source of income was from other sources. I forget what the general rules were. There would be some limits with it; if you had a constant loss over a period of years and most of your income was from another source and it was obvious that you were just using the farm to charge off expenses against other income, over some period of time, you received different tax treatment. I don't think, Chuck, we've ever been able to adopt one of those proposals, have we?

Mr. Ludlam. Not that I remember.

Senator Bumpers. It's called the Drugstore Cowboy Bill. The purpose was to keep people like me, who is a lawyer, from going out and buying a farm, raising cattle, and charging off losses against my other income. Do you all have any feelings about that? Do you think that if doctors, lawyers, whoever, want to get in the farming business they have the right to under the same rules that everybody else does?

Mr. Purtle. I think that the theory is probably across the Nation that the tax shelter program benefits on the short term because these are the people naturally that have the money that they can put the cash input in. If you are doing business with them, it's a great deal, perhaps at the time. In the long run, it is a situation that hurts the cattle industry. We have had, I believe, in years past provisions where you had to make a profit 3 out of 5 years, which sees a vast turnover. Of course, these people primarily get into purebred cattle because of the high dollar on account of the amounts that are involved, of which the writeoff isn't so great. Under this tax provision, if the tax rate is lowered, the incentive for getting into the tax shelter won't be as high. But it would hurt the cattle industry on the near term, just completely eliminate it, but over the long haul, it would probably be good, because then we would be able to buy the breeding stock on a competitive level at a more fair price, an equitable price.

Senator Bumpers. I agree with you that breeding stock, just like the machine that produces something, is a depreciable asset.

Mr. **Purtle**. The frightening thing about it is—because just the nature—the cattle business for some reason has a lot of glamour to it for some people.

Senator **Bumpers**. It did at the time that I got into it, but in isn't the reason I got out.

Mr **Purtle**. It's the only business like I said before that I know of where the man and his wife go from work in town and buy feed at the feed store and feed his cows and not keep up with what it costs and say that they make 100 percent profit on it. But the thing about it is, if some of these things are implemented into law whereby they have to keep records of these deductions in this 2-year period, before they sell their cow and they can regain it, that means they are going to have to keep records for 10 years. People are not going to do it. They are going to literally lose that money. It will never be able to come back to them under the recapture.

Senator **Bumpers**. You know, Ned Ray, when I was Governor, I made $10,000 a year. When I went to the Senate, my salary jumped to $42,000 a year. And for the first time in my life, I averaged my income, and made a little money out of it. I can remember in 1976, I sold my interest in a nursing home in Charleston and got some money out of that and I used income average then.

I have never really been very favorably inclined toward income averaging. And as you know, you touched on this, the President's proposing to eliminate income averaging here and I'm not sure whether that's a small business issue or not. Quite frankly, I have not really thought about how that affects people, particularly the timber or cattle industries. Sometimes, you know, people will buy calves and keep them if you are cow/calf operators; that's not always true, but a lot of times people will buy 100 heifers. I'm talking about 400-pound yearlings. Then you raise and breed them and you know there's a period of 3 years goes by before you realize any income. Then you realize all of your income at one time.

So there's 100 cows, 100 calves, and you've had nothing but expenses the first 2 years and all of a sudden you have a whopping income on the third year. I can see why income averaging would be important in a case like that. And John Porter, I can see where income averaging would be important to a tree farmer who may raise trees for 25 to 40 years and all of a sudden get all of his income at one time.

Gaines, just where you're sitting, why don't you comment?

Mr. **Norton**. It is a small business issue, some small business becomes big business. That's where big business comes from. And they benefit from income averaging as they grow. Once they get big, once you are paying the top bracket, you don't benefit any more. So, it's a definitely small business issue.

Senator **Bumpers**. Do you favor the retention of income averaging?

Mr. **Norton**. I favor retention and then if you are in an industry that has its ups and downs, like the cattle industry and like the farming industry, it takes the bumps out of your income. It tends to levelize.

Senator **Bumpers**. I had really never thought about that before.

Mr. **Purtle**. It can be—the history of folks in the cattle business, as you said—you don't have that real good payday every year. For some reason other than you sell all or part of that breeding herd and that's the time when these things are vital to you. And you have to pay up front on a flat rate tax on what you'd get that year because it takes you a period of time to produce it. Averaging is very important.

Senator **Bumpers**. You know, Ned Ray, politicians are put in a very precarious position in the State of Arkansas, perhaps as much or more so than in almost any State in the Nation, because, as you know, commodities are at an 8-year low right now. We have to go to east Arkansas and do everything we can to help those farmers get the price of their commodities up; but this has an adverse impact on the poultry and cattle industry.

John Porter timber still employs over 60,000 people in this country. They are still the biggest employer in the State, but poultry is rapidly catching up and now is running a very close second to the timber industry as the biggest employer in the State. So anything that adversely affects the poultry industry hurts the State and the cattle industry of course is bad hurting already. Cattle prices are down pretty dramatically; has that decrease in price been offset by the lowered cost of grain—corn, wheat, soybeans? These prices are all diving now?

Mr. **Purtle**. Not really. It's the average cattle that come out of the feedlot and I know that we don't have a feedlot business in Arkansas. By the average cattle that come out this summer in July and August have probably lost like $140 a head. Even with the cheaper feed. Had feed been a year or 18 months ago level, the losses would have been $200 a head. The loss has been less. The loss is there. It hadn't affected us in Arkansas as much, except had feed costs not gone down, we wouldn't have gotten quite as much for the feeder cattle that we sell, even though we are at probably last year's price levels. Really we've been charted all year, but from this week of this year to last year, there's been very little difference. It doesn't seem like that's so because our numbers are not that long. We remember what they were in April and how much they've gone down and what's gone down in late June until now. Had it not been for that situation, cheaper grain, we would have seen a much less—we would have had a further decline in our feeder cattle price and that would affect the cattle market. But, this is the tragic part of income. Usually when one's up the other's down. We've had the timber program and the dairy diversion program and all of those things have impacted negatively against the beef cattle industry.

Senator **Bumpers**. You've heard the story about the farmer meeting the other on the street and said "I just lost $100 this morning" and he said what happened? And he said "my cow had a calf."

John Porter, talking about the timber industry, you made one interesting point and that is the small mills such as yours are dependent on the big mills and their prosperity. The large mills are the ones which are being so tremendously impacted by imports, notably Canada. As you know, 40 percent of all the softwood lumber in this country now are being imported from Canada. That's up from about 5 to 6 percent in 1980. These imports are being heavily subsidized by the Canadian Government. As I said in a short interview with the press this morning, I have always supported the

President on his trade issue until just recently. But, it's one thing to be a fair trader and it's something else to be stupid. When you consider the fact that we are now a debtor Nation for the first time in 72 years and is running a $125 billion trade deficit against other countries this year. We leave our markets wide open to everybody and we let the Japanese—and I'm not in the business of Japan bashing but, they use so many little cute tricks over there to keep us from selling in their markets—run up their exports into our market. For example, under their health insurance programs, they won't pay you if you use anything except Japanese medical equipment. The United States is head and shoulders above any other country on Earth in sophisticated health care equipment. So, the Japanese Government said well, we don't have any barriers for your products here. They don't have any barriers, but they use this little insidious process like that, where a private industry—the private health care industry over there who is like our counterpart to our Blue Cross-Blue Shield—they just say that they don't pay claims on hospitals that use anything but Japanese equipment. Well, that's not the official policy. That's a private policy and yet, it excludes the manufacturers of health equipment from that country. They let timber producers in Saskatchewan take timber for $2 to $10 a thousand board-feet off the stump, and John Porter, he goes to the National Forest Service and he has to bid on it. It costs him $180 to $200 a thousand. We can't compete with that.

So, what I am saying is: you can't separate tax reform and our economic conditions in this country from the most growing problem that we have and that's foreign imports.

I think the President's getting ready to say that he's not going to do anything about shoe imports, and shoe imports represent over 70 percent of all the shoes sold in this country. I'm not sure we could even manufacture enough combat boots for service people with the little amount of the shoe industry that we have left in this country. And, as I say, while I am essentially a free trader, I just think there comes a point where you have to deal with that issue. Certainly, the timber issue is a classic case in point, where International Paper Co. is shut down at Pine Bluff right now because of Canadian paper flooding this country at a price that they can't even begin to compete with.

A VOICE FROM THE AUDIENCE. Senator, could you get the same thing with fuel and steel?

Senator BUMPERS. The end is limitless. I guess Victor's saltine crackers are the only thing here that isn't subjected to competition.

Mr. CARY. We're not worried about it.

Senator BUMPERS. In touring the State, which I do almost every weekend in this State, I go through these plants—I never go through a plant that isn't being impacted very severely by imports. And, as I say, within limits, that's fine. We need free trade. But Congress has literally invited Don Flanders to take his plant overseas. To me that's a strange policy for any country to have.

Mr. PRICE. The thing we rush to deal with—we can't wait, I think, time is running out and that is the budget, the deficit is killing us. The strong dollar is what is killing the paper business. That most assuredly makes us unable to compete on the world market and as we lose these markets, it's just like what happened to farmers when the embargo appeared. They lost those markets and have not been able to regain them. And we are dealing with a foreign competitor who is not backward, he is very forward and he builds good plants, has good resources and they are good. And they are going to—they are taking the markets away from us. We just don't have a chance with this strong Government to compete with them.

Senator **Bumpers**. John Porter, let me make a comment on that. I agree that the strong dollar has really hurt us from a competitive standpoint. But by the same token, I thought when interest rates in this country began to decline that people would take their dollars out, forcing the dollar down. One hundred billion of the $200 billion Government deficit in this country is being financed by foreign investment. The Europeans and the Middle Easterners are investing in this country because they still see us as the most stable economy in the world, probably the country with the best future. Now, we're getting to the point where our interest rates are as low as interest rates in other countries and yet they are still not taking their money out. We thought that when the interest rates went down that these people were going to take their money out and they have not. That's one of the reasons for the dollar remaining strong.

Let me just conclude by saying again how much I appreciate all of you coming. Senator Pryor is holding hearings all over the State on the tax reform bill in a different context. He is asking for general comments from a public—ours is more narrowly focused on small business tax issues. I am the ranking member on the Small Business Committee and felt some obligation to see how the bill would impact small business. I must say that I always learn a lot from these hearings. In the last 6 years, I have been going around the State holding what we call Town Hall Meetings when we are in recess. At most Town Hall meetings—sometimes a guy with a sixth grade education can tell you something that is pretty profound, that you wouldn't have thought of otherwise. They are very instructive and educational and this hearing has certainly been helpful to me. It may have been more helpful to me today than it has been to the people who have testified. But I want to thank all of you for coming.

In conclusion let me say that everybody is for tax reform. The one thing that Jimmy Carter said that was correct was that our Tax Code is a disgrace to the human race. What we want is fairness and simplicity.

People are amazingly patriotic in this country. I think they recognize that we are in difficulty with these deficits. Harry Truman told me one time, the first year I was Governor and I went to see him. I was asked to give a speech and they told me that if I'd go up there and speak at a Truman Day Dinner, I could spend an hour with him. So I did and it was one of the highlights of my life. I am a big admirer of his. You know today we have to look and sound good on those 30-second television commercials to be elected to anything. By this standard Harry Truman couldn't be elected dog catcher. He had that little nasal twang voice, horn-rimmed glasses, and plastered his hair down with vaseline. In today's market, he couldn't be elected to anything and yet historians now consider him to be one of the greatest Presidents that this country ever produced.

When I met him I was lamenting to him about what a tough job being Governor was and of course, that was because I was just a country lawyer and it was all new to me. And he told me that. He said, "You'll get used to it, but the thing that you always want to remember is trust the people with the truth. No matter how bad things may be, they can't deal with it if you mislead them or deceive them. Tell them the truth because they can handle it. And they'll be willing to do anything to deal with it, if you put it to them right." We are in big trouble with these deficits. To try to conceal that or mislead people about the possible devastation their going to wreak on this country is grossly unfair.

I also think that it's important to talk to people about this tax bill, educate them as to what it does and what it doesn't do and then get their comments as we have here today. I think that that's democracy at its very best.

Thank you all, again. We will stand adjourned.

[Whereupon the committee adjourned.]

IMPACT OF TAX REFORM AND SIMPLIFICATION PROPOSALS ON SMALL BUSINESS

WEDNESDAY, AUGUST 28, 1985

U.S. Senate,
Committee on Small Business,
West Memphis, AR.

The committee met, pursuant to notice, at 9 a.m., in the city hall building, West Memphis, AR, Hon. Dale Bumpers (acting chairman of the committee) presiding.

Present: Senator Bumpers.

Staff present: John W. Ball III, minority staff director and chief counsel; Charles E. Ludlam, chief tax counsel for the minority; Lawrence G. Dalsin, professional staff member.

STATEMENT OF HON. DALE BUMPERS, A U.S. SENATOR FROM THE STATE OF ARKANSAS, AND ACTING CHAIRMAN, COMMITTEE ON SMALL BUSINESS

Senator Bumpers. The committee will come to order. Before getting into my opening statement, I want to thank Mayor Chitman and the city of West Memphis for allowing us to use this really magnificent facility this morning and to say that, of course, one of the reasons we came to West Memphis and Crittenden County is because it is such a hospitable place to come to. When I first started running for Governor, I decided that West Memphis had the welcome mat out in about as fine a form as any city in the State. I developed a lot of friends here at that time, discovered that they have great leadership here, a city that's really on the move and probably works as hard as any city in the State of Arkansas to develop itself. Under the sort of big shadow of Memphis it makes it much more difficult, but the people of West Memphis like Avis try harder. We wanted to hold two hearings in Arkansas, and often times people just do things in the center of the State in Little Rock and they forget that people out on the edges of the State also have deep and abiding interest in these issues, and so we chose Fort Smith and West Memphis to hold these hearings. The downside of that is we had to ask some people to drive rather long distances to come and testify. I apologize for that inconvenience, but this is a very major piece of legislation that the President has proposed. It will dramatically impact virtually everybody, and we felt it was necessary for us on the Small Business Committee to get out across the country and discuss this matter with the people who are going to be most affected by it, either favorably or adversely.

So, Mayor Chitman, thank you for your warm hospitality.

STATEMENT OF HON. LEO CHITMAN, MAYOR, WEST MEMPHIS, AR

Mayor CHITMAN. Senator, let me say on behalf of our city council and citizens of West Memphis, the elected officials, we are delighted to have you select our city and we hope the hearing here will be quite beneficial and the Federal legislation will be something we all can be appreciative of. Again, we want to express our appreciation to you and hope in the future you will select West Memphis to have conducted hearings that will be beneficial to all of us. Thank you very kindly and have a good day.

Senator BUMPERS. Thank you again, Mayor.

Let me begin this morning by welcoming our witnesses and thank them for taking off valuable time. For business people, especially small business people, time represents money; so I know that some of you are making some financial sacrifice to be with us this morning and to testify before the Small Business Committee.

Small businesses constitute the bulk of business establishments in Arkansas. Out of 42,000 businesses in our State, 24,000 have 4 or fewer employees, and 38,000 of those businesses have 19 or fewer employees. Nearly 200,000 employees work in these small businesses. More specifically, here in Crittenden County 444 of the 775 businesses have 4 or fewer employees, and 668 of them have fewer than 19.

There may well be no issue in the tax bill that is more important than its impact on small businesses. If the tax reform bill is not helpful to small businesses, then it is not reform.

This hearing is part of a series of hearings on the impact of tax reform on small business. Previously the committee has held 11 days of hearings in seven States. All these hearings will be published by the committee and will be forwarded to the Senate Finance Committee and available to all Members of Congress and the public for consideration. There is perhaps no legislative issue pending before the Senate which potentially affects more people in our country than tax reform. Everything we do as individuals or workers has tax consequences and most people are at least aware of the tax angle when they make various kinds of economic decisions. In fact, one of the key issues in the current debate over taxes is whether too many decisions are made based on tax incentives or disincentives, rather than on purely economic grounds.

I think today's witnesses will find that they have much in common in their views on tax reform, but they may also be surprised at how different is the impact of the President's proposal on different kinds of businesses. One's view of tax reform depends on one's current sources of income, the types of expenses one incurs, and the degree to which one relies on various tax preferences.

For many small businesses, the proposed reduction in the tax rates will more than offset the loss of tax deductions and credits. For others, the loss of even one current tax deduction might make a crucial difference between being competitive and being insolvent. That is what the committee needs to know more about as we review the tax reform proposals over the coming months.

The Senate Finance Committee has held many days of hearings on tax reform in Washington. At these hearings the major small business groups have testified generally in favor of the President's tax reform proposal, particularly the lowering of tax rates, the reduction in the capital gains rate, and the retention of the progressive tax rates. John Motley, who is chief lobbyist for the National Federation of Independent Businesses—that's the largest small business organization in the country—said the other day that the President's proposal is preferable to the current Tax Code. At the same time, these groups have expressed concern about the repeal of the investment tax credit, the restrictions on the use of the cash method of accounting, and the partial taxation of fringe benefits. So I am here to find out what you think about these issues.

Of course, everyone would like to see lower tax rates while retaining all the current tax deductions and credits. But, with Government deficits running $200 billion a year—really, in excess of $200 billion—we can't afford a tax cut. In fact, one of the most important questions about the President's proposal is whether it would aggravate the deficit problem. The Joint Taxation Committee has found that the President's proposal would increase the deficit by $25 billion over the next 5 years.

It is tempting for each of us to think more about what tax deductions and credits we are losing in tax reform. It is important, however, that we focus on the bottomline. We can't have lower tax rates unless we restrict or eliminate at least some current tax preferences.

One central feature of the President's proposal is that it substantially raises business taxes to pay for substantial cuts on the individual side. Under the President's proposal business taxes rise by $122 billion over the next 5 years and individual cuts drop by $147 billion. I am interested in your views on whether this shift in the tax burden makes economic sense. I must note that business taxes accounted for 17 percent of all the revenues collected by Government in 1970. Today it is barely 6.2 percent.

We have many witnesses to testify here today, so I want to ask each of you, please, to limit your oral statements to 5 minutes. If you have longer written statements, we will enter the entire statement in the record, and it will be included in our hearing record and transmitted to the Finance Committee. After each panel has spoken, I will have a few questions.

Again, I want to express my gratitude to all of you who have helped us set up our arrangements, particularly to all the witnesses who have come to be with us this morning.

Our first witness this morning in Paul Hughes. Paul, are you president or chairman of the Farmers'——

Mr. HUGHES. President.

Senator BUMPERS [continuing]. President of the Farmers' Soybean Corp. of Blytheville. He manages a grain elevator for soybeans, wheat, and milo. He's been in the business 34 years. He also manages the Hardware Farmers' Supply Store; 15 years in that. Paul, did you know I was a hardware merchant before I was Governor?

Mr. HUGHES. No; I knew you was a lawyer.

Senator BUMPERS. I like to forget that and talk about my hardware store.

In any event, Paul, we are very pleased to have you this morning. If you will, just take this seat right here.

As a part of this two-person panel we have Don McKnight. Don, where are you?

Mr. McKNIGHT. Right here.

Senator BUMPERS. Come on up and take a seat beside Paul here. Don is a farmer in Parkin, farming 1,500 acres of beans, milo, rice, wheat, and peanuts. He is also a sales representative for IBM. I thought that was a strange combination: farmer and salesman for IBM. That makes you fairly unique in testifying this morning.

Paul, if you will, since I have your name first, will you please proceed.

Mr. HUGHES. All right. All these titles are in lieu of pay increases.

Senator BUMPERS. I understand. If you are a farmer, everything is in lieu of pay these days, isn't it?

STATEMENT OF PAUL C. HUGHES, PRESIDENT AND CHIEF EXECUTIVE OFFICER, FARMERS' SOYBEAN CORP., BLYTHEVILLE, AR

Mr. HUGHES. My name is Paul C. Hughes and I am president and chief executive officer of Farmers' Soybean Corp., Blytheville, AR, a small business with 67 stockholders, 9 directors, and 19 employees. We are a country grain elevator; a service business but a capital-intensive business; and our customers, the farmers, are also in a capital-intensive business.

Senator BUMPERS. Paul, let me suggest you pull the microphone closer. This is like being in the Senate: You have to get it up close so they can hear you.

Mr. HUGHES. I can holler in one of these things, but I thought it was a good set.

I am grateful that the President has introduced his package of tax reform proposals, and I am equally grateful that they are seriously being discussed by Congress and this committee in particular.

Taxes should be fair, simple, and encourage the growth of our economy. These three points should override any idea that tax reform should be revenue neutral. Rates could be changed to make them neutral if the tax is fair, simple, and encouraged the growth of our economy.

However, as I study the President's proposed changes, it becomes clear that our present system has become so embedded in our current economic system that I truly wonder if taxes can be reformed only on the basis of being fair, simple, and encourage the growth of our economy. As the executive of a capital-intensive business, I think the current system of investment credit and depreciation is fair, simple, and encourages the growth of our business. However, the President's proposal would do away the investment credit and make depreciation a nightmare.

On the other hand, as a product of the depression I am fiscally conservative, being careful with my personal funds as well as company funds and avoiding debt as much as possible. I feel quite strongly that allowing an unlimited deduction for interest first helped fuel our runup in inflation and now has increased the vulnerability of our economy because too many of these investments were made on the basis that prices could do nothing but go up and that Uncle Sam was helping to pay for these investments by the reduction in income tax. However, the President's tax proposal does not change this at all.

These differences of opinion run throughout the President's proposal. This room is full of folks with different opinions, and I am sure when you get back to Washington the Halls will be full of folks with different views on almost every proposed change.

I have neither the time nor the ability to address these proposed tax reforms on a 1-to-1 basis. However, I do ask you and the other Senators as you consider these proposals to keep in mind the needs of small businesses to be treated fairly in all these tax proposals. Taxes should not give big business an unfair advantage over small businesses. They need to be simple, and they need to help us keep growing as increases in employment come faster from small business than big businesses.

In our business we need to be able to keep enough funds available to make those improvements and investments in our business to keep us competitive with the large businesses in our field.

In closing I would like to thank you for giving me a chance to ask for fair and simple taxes that will allow our firm to keep growing.

Senator **Bumpers**. Paul, thank you very much.

Don.

STATEMENT OF DONALD McKNIGHT, FARMER, PARKIN, AR

Mr. **McKnight**. My name is Donald McKnight, a farmer from Parkin, AR, a small rural town in east Arkansas located about 40 miles west of Memphis, TN. I operate a 1,500-acre farm, growing soybeans, grain sorghum, rice, wheat, and peanuts. Beginning this winter, I will be entering the business of growing Christmas trees for both wholesale and retail trade. The farming operation requires the labor of myself and three full-time employees with a capital investment of approximately $300,000 in equipment alone, and at today's prices will annually produce gross sales of approximately $350,000. This past year I have also begun a new business as an independent sales rep selling IBM personal computers and the related equipment and software with my efforts directed mainly toward farmers. I am also a past president of the Parkin Chamber of Commerce and am a member of its industrial development committee. If I appear before you today as a spokesman for my particular group, it would be for farmers and small businesses located in the small towns across the rural area of eastern Arkansas.

The idea of a tax simplification or reform is of interest to all and we thank you, Senator Bumpers, and the Small Business Committee for conducting these hearings in West Memphis.

It's rather ironic that I should be addressing the question of tax reform since the ag economy has taken care of this problem for me the past few years: If you don't have a net income, you don't pay any income taxes. However, with the proper attention of the administration and the Congress, we will survive this farm depression; and we will need a tax system that will allow recovery to take place.

It is very admirable for anyone to even propose a simplified income tax system. After all, it is rather absurd for a business with only three employees to need the services of a tax accountant to keep abreast of the tax regulations to operate within them. My accountant tells me that the confusing complexities of the current system comes mainly from the constant changes being made by the Congress and from the constant reinterpretation and rewriting of regulations by the IRS. When you plan for the coming year, you have no assurances that the tax regulations in effect at the time of planning will be in effect for the remainder of the year.

Since the vast majority of small businesses and farms are unicorporated, the reduced tax rates for individuals is very appealing if the additional burdens affecting capital investments do not cancel out any gains made through the reductions.

The simplicity of the expensing of assets is very appealing; but since the President's proposal seeks to permanently limit the amount which could be expensed to $5,000, this will make it very expensive to purchase new farm equipment or to invest in a new plant location in a small town in east Arkansas. The only other way to recover these costs would be higher prices. Currently, commodity market prices are way below costs of production without the additional burdens of limited expensing of assets or the complicated idea of indexing for inflation under the proposed capital cost recovery system.

This leads into the proposed elimination of investment tax credits from the Tax Code. The farmers in east Arkansas and the small businessmen in the rural areas are already suffering, and the merchants might be able to find relief from their misery by locating small manufacturing plants in their communities. One of the prime incentives for a company to build a new plant is the investment tax credit. To eliminate such an alternative will bring a further slowdown in industrial expansion in these small towns and further eliminate any hope for the survival of these communities. As far as the farmer is concerned, and since he is already under the gun, this will eliminate further purchases of equipment and machinery and will drastically affect the wellbeing of those manufacturers and their suppliers. Agriculture is a leading user of steel and rubber in this country; and when you eliminate purchases of new equipment, it is easy to see the resulting effect on these industries and their employees.

The President's proposal would limit the deduction for interest expense to $5,000 plus investment income. I am not entirely clear as to how this will work, but since all farms and most small businesses in this area depend a great deal on borrowed money, we would like this clarified to reflect that the limits will not apply to investments in a business in which the investor is an active participant.

The President's proposal limits the use of the cash method of accounting to those businesses: First, whose gross sales do not exceed $5 million; second, who have no inventory; and third, who use no other method of accounting to ascertain the income, profit or loss of the business for the purpose of reports or statements. I understand farming may be exempt from the third condition, but it will apply to the many small businesses who regularly borrow money and who furnish statements to the lenders showing any inventory, and they will be forced to use the accrual method which will require a more sophisticated accounting system than many of them now use, and will also increase their taxable income by the amount of their receivables or billings. All of this will place additional costs of doing business on these merchants who have enough problems already.

If the bad debt reserve is repealed along with the changes in cash method accounting, we will see small businesses actually being taxed not only on money not received; but also on money that they will never receive.

It is impossible to understand any sense of fairness or sense of justice when it is proposed that all deductions for State taxes will be eliminated from all but corporate returns. Most small businesses and farms in this area are operated as unincorporated businesses, and why should they be forced to pay Federal taxes on money already paid to State government and corporations be excused? Business income from incorporated businesses should be taxed the same as business income from unincorporated businesses.

The issue of income averaging is a very important one for farmers. Again, the corporations have the opportunity to carry losses forward and back, but unincorporated businesses such as are most of our local farmers and merchants will be denied this practice. After these tremendous loss years suffered by farmers, the elimination of income averaging would assure bankruptcy even if prices were to improve to a profitable level. If we could not carry the losses forward to the years in which we might make a profit, there would be no way to pay off the debts incurred during those loss years.

Gentlemen, I realize that much of this presentation has been negative, but frankly the tax reforms as proposed by the administration are way down my list of priorities at the moment. The only salvation for the farmers and small businesses in the communities dotting east Arkansas is for the President and the Congress to address the problem of farm markets and the balance-of-trade deficits facing us today. After these are solved, then the idea of tax reform becomes very important, and we offer these comments to you for your consideration.

Thank you for allowing us to present our views on these provisions of the President's proposed tax reform. As stated earlier, some of the complexity of the current code seems to be the neverending changes taking place, and we will ask that you avoid as much as possible frequent changes in any new tax unless you might enact.

Thank you, sir, for conducting this hearing in east Arkansas.

Senator BUMPERS. Don, did you grow up in east Arkansas?

Mr. MCKNIGHT. Yes; I did.

Senator BUMPERS. I can't tell you how impressed I am with your statement. Did you prepare that yourself?

Mr. MCKNIGHT. Yes, I did, sir.

Senator BUMPERS. I hope you don't decide to run for the Senate because you and I think exactly alike. I don't want to reveal my hand on tax reform, but I agree with every single thing you said in that statement. And I am not opposed to tax reform. I champion tax reform. I am one of those crazy 11 people who voted against the tax cuts in 1981 because I said we ought to balance the budget first and then start talking about tax cuts. You know, I honestly believe there were very few of the other 89 Senators who thought that you could cut taxes, double defense spending, and balance the budget all at the same time. So you know where we are right now, without me cataloging all that, but I just want to say I am so impressed with your statement.

David Pryor said one time when he was up at Newport making a speech—he said: "How many people in here would not mind seeing taxes increased if you knew all the tax increase was going to go toward reducing the deficit?" He said he was afraid they were going to start throwing tomatoes at him. Everybody held up their hand. He was really shocked. When he started to leave, one of the farmers came up to him and said, "Senator Pryor, you know the reason those farmers held up their hands?" He said, "No." And he said, "Because they ain't paying any taxes anyway."

But let me just ask both of you this question and, Don, I'll start with you. I think I already know the answer to it because you pretty much said this in your statement. But if you had a choice right now between current tax law and this present proposal—just that narrow option—if you had to choose between the current tax law and the President's proposal with fewer deductions and lower tax rates, which would you choose right now?

Mr. McKNIGHT. I would have to choose the current tax regulations.

Senator BUMPERS. That's the answer I got all day in Fort Smith yesterday, and Slade Gorton, Senator from Washington, who is on the Small Business Committee and who has been holding similar hearings out there, tells me that's the kind of response he's getting.

Paul, how about you for that same question?

Mr. HUGHES. I may not be—I think it needs to be considered. There are inequities in the taxes. You know, they are so engrained it gets hard to figure out where they are, but on the other hand I do not quite think we are ready for a total change in our tax system because, you know, with the economy in the shape it's in, if you are wrong it could take us back into a depression pretty quick.

Senator BUMPERS. Paul and Don both—Don alluded to this in his statement about the constant changes in the code and particuarly the way the IRS writes regulations. It's kind of like the automobile laws. We passed a one-sentence law—I say "we," I didn't. I voted against that in the first place. We just had a one-sentence provision in a tax bill which I didn't think was a good bill. I didn't vote against it because of that one sentence in it, but I voted against it because I didn't think it was a good bill. But the IRS took it and started telling everybody they have to carry a log in their car and keep up with every stop they make and all that sort of thing. That's what happens. And it's that constant change in the Tax Code that drives people who try to plan their businesses up the wall. It drives accountants crazy because they can't keep up with it. You know, then you come along with this big tax reform. And if we are going to do this, it seems to me we ought to do it very, very carefully.

You remember in 1981 we passed that massive tax bill and do you remember the so-called safe harbor leasing provision in that bill? That bill was 952 pages long. But obviously nobody understood how that safe harbor leasing system was going to work. One of the ways it worked, it allowed General Electric, good corporate citizen—nothing wrong with them; they simply took advantage of the law—it allowed them to make $6.4 billion in the next 3 years and actually get refunds of $287 million from the Treasury. They didn't pay any taxes; got $287 million refund. And, you know, that's the sort of thing we ought to be trying to redress.

Let me ask you this question, Don: If the only way to reduce the deficit would be by raising some additional revenues were fenced, as we like to say, so that it could only be used to reduce the deficit, would you support that?

Mr. McKnight. You answered that a minute ago when you quoted Senator Pryor. None of the farmers are paying taxes anyway.

Senator Bumpers. You can make a very objective opinion about it because it isn't going to affect the farmer.

Mr. McKnight. I know in my business I have never been able to balance my budget by reducing revenues and not reducing spending. So, yes, I think that if it were necessary——

Senator Bumpers. In 1983 Senator Hollings and I introduced an amendment, budget resolution, that would balance the budget in 1986, and we got 18 votes for it. One of the reasons is because we did have some revenues in there. As a matter of fact, I know both of you feel strongly about the investment tax credit, but we even phased out investment tax credit; we lengthened depreciation a little bit; and we established a minimum corporate tax because, as you know, 60 of the biggest corporations in America made $50 billion the last 3 years, paid no income tax, and got $3.5 billion in refunds. You know, we all know, that's not right. That's not fair. But, anyway, we got 18 votes.

In 1984 we came back, offered the same resolution that would have balanced the budget in 1987, and we got 38 votes. And we would have passed it, quite frankly, if the President had not had all his men working on the floor of the Senate. In 1985 we came with essentially the same one that would have balanced the budget in 1990, and we got 35 votes. We lost every time because we had revenues in there. People said, "You can't raise taxes." Well, I don't like the idea either, but I don't like a $200 billion deficit.

Have you made any decisions, Paul, in the last 3 years to buy equipment because of the investment tax credit or because of tax depreciation available to you or any other tax advantage?

Mr. Hughes. Oh, yes. We have just this summer installed a new leg at one of our elevators, and we figured the cost of it in how quick and how much money we had to make out of that leg to justify paying it using the investment credit and this current, what, 5-year depreciation schedule on machinery where you can depreciate it out in 5 years down to 20 percent, I believe it is.

Senator Bumpers. Yes.

Mr. Hughes. And this is what—we put a new scale in and looked real hard at putting a new dryer in and probably would have if we had a new farm bill, but we wanted to see the new farm bill before we spent the quarter of a million dollars.

Senator BUMPERS. Don, have you made any decisions in the last 3 years based on accelerated depreciation, investment tax credit, or any other tax advantage?

Mr. MCKNIGHT. I have not made any major equipment purchase in the last 3 years, but I still have unused investment tax credit from the purchases I made 4 years ago. That played a very important part in our decision.

Senator BUMPERS. Let me ask you this question. I was a small businessman for 18 years before I got into politics, and I have to confess I wasn't making enough money to worry too much about the tax consequences of my decisions. I had a man testify yesterday—he has 250 employees in what's called the Wortz Co. Seventy percent of their business is making saltine crackers—and he told me that he takes advantage of anything in the Tax Code, but he said his investment decisions are made on whether or not that piece of equipment will make him any money or not. Now, they are not necessarily exclusive: those two things. Actually, it will make more money, obviously, if he can get a tax credit out of it, but that's not the thing he looks at. First, he looks at whether it is going to improve his productivity, will it cut his costs over the long haul, and so on.

Do you agree with that, or do you think most people just make decisions based on whatever the tax incentives are available to them?

Mr. MCKNIGHT. Certainly the main consideration would be on whether or not it would be profitable to purchase the machinery. In my case we eliminated additional equipment—by buying larger tractors we eliminated two small tractors. But when it comes time to pay for it, the investment tax credit is very important.

Senator BUMPERS. Do both of you keep books on a cash accounting basis?

Mr. HUGHES. We are on an accrual basis.

Mr. MCKNIGHT. I'm on accrual also, but most of my neighbors are on a cash basis.

Senator BUMPERS. I take it you don't much like the $5 million limit the President is proposing on accrual accounting. As I understand the President's proposal, if you do over $5 million a year you are going to be required to go to accrual accounting.

Mr. MCKNIGHT. That part doesn't bother me. The part that bothers me is if you use accrual accounting in making a statement, when you go to borrow money you will be forced to use accrual accounting to keep your records for tax purposes as well.

Senator BUMPERS. That's right.

Mr. HUGHES. Even if it's done on the back of an envelope, is the way I understand it.

I think the man with Wortz is right. We didn't make the decision to put the leg in because we were going to get the tax credit; we made the decision to put it in because we needed it. But we used all this to justify how we were going to pay for it and when we could pay for it. If we figured it wasn't going to make any money, we weren't going to hang it up just for the beauty of the thing.

Senator **Bumpers**. Let me ask you both something quite aside from the effect on small business, just from an equitable standpoint. I'm really curious about this. This chart right behind you here shows that the proposal that the Senate is considering has that impact in 1987. If you make under $10,000 a year you get a $42 tax cut. Let's take, for example, in Arkansas the median family income—that is, the average income for a family of four in Arkansas—is about $20,000 a year. You can see that that family is going to get somewhere between $165 and—I'm sorry. Yes, around $198 a year in tax cuts.

Now, as I stated in my opening statement, all these cuts for individuals are coming from an increase in business taxes. I don't mind telling you that my own preference would be to leave everything as it is if you are going to raise taxes on business and use that to reduce the deficit; not to cut other taxes. But you can see over there if you make over $200,000 a year you are going to get a $23,000 tax cut. Almost 10 times as much as you get if you make between $100,000 and $200,000. So, you know, the very rich are going to do very well under that.

Now, if you look at this chart you can see the change—that's how much money you have after you pay this tax. This is the after-tax effect. But there is another chart that I don't think we have right now that shows as a percentage of income the people who make under $10,000 a year and the people who make over $200,000 a year are the ones who are getting the biggest benefit as a percentage of income out of the Tax Code. As most people in the middle class think, they are the ones that get the least.

How does that strike you, Don? Since you and I don't make $200,000 a year we can be very objective about this.

Mr. **McKnight**. Right. It doesn't sound like what I read in the media of what the tax reform program offers.

Senator **Bumpers**. That certainly doesn't look like it addresses the fairness issue.

Mr. **McKnight**. Right.

Mr. **Hughes**. That's the main thing. It just does not. You know, if you get a tax reform, the more taxes you pay, you know, maybe the bigger the dollar amount you would get; but this is out of all proportion. And this one over here isn't a steady decline. It's all at once. It just goes right to the top. This is, I think, the unfairness of it.

Senator **Bumpers**. I think if you were to just walk down the streets of West Memphis and asked people what they thought about the Tax Code they would probably spit first and then say, "It's unfair; it's too complicated; and I'm tired of paying accountants to keep up with it and have to pay somebody to do my tax return." Fairness and simplicity are the two things that people really want in the tax reform more than anything else, and unless it addresses those two things it's hardly worth the effort because the cynicism about taxes in this country is very high. And if you are not going to make it fair, if you are not going to make it simpler, I see no reason to go through the trauma of this whole experience.

I might make two other personal observations. You know, I have a small problem on the investment tax credit. If we eliminate the investment tax credit which the President is proposing, that's a pretty big ticket item. It raises a lot of money for the Treasury. One of my biggest contributors is president of the biggest leasing company in the world, and he's also a very good friend. And his whole bottom line is based on the investment tax credit, and his name is Carroll Bumpers. He's my brother. So, you see, I have family problems in eliminating investment tax credit. But I don't know whether the investment tax credit does anything more than just give people—you know, Jack Kennedy was the first person to come up with the investment tax credit. It was originally 7 percent and it was designed to entice businesses to expand and to modernize, and so on, by giving them a 7 percent investment tax credit. It's gone up, down sideways, and every other way. Right now it's 10 percent.

My concern about that is if everything were on a level playing field and nobody got the investment tax credit, it certainly wouldn't affect the competitive advantage that anybody had. It would take away, obviously, a tax credit that's desirable and that they would like to have. But if nobody had it, then everybody is sort of back on the same playing field, aren't they, Don?

Mr. **Hughes**. I think you can eliminate investment credit much easier than—but we had simplified depreciation, and to eliminate both of these then you really have got to go to a CPA. My CPA said, "I'm not really sure that I can figure depreciation, you know, under the proposal in this tax deal because IRS is going to try to make a determination of what the depreciation is on each and every item. Maybe if we stop inflation; but as it was, depreciation was not keeping up with the payments.

Senator **Bumpers**. You know, there is some indexation of capital assets in here and that are being depreciated. There is also indexation on capital gains. I have trouble with indexation. I don't want to pursue that right now, but I have trouble with indexation because every country in the world that's tried it, with the exception of Canada, have found that people don't really care how high inflation is because they have it indexed anyway and I think it causes people to let their guard down. There is a very powerful, presuasive argument for indexation. I understand that. And I am reluctant to take this position. I have consistently opposed it in the Congress because I didn't think we could afford it. We just keep cutting; the deficit keeps going up; and everyone wants the cuts but nobody wants the deficits. That's the contradiction we are in.

You both have been excellent witnesses. They were both great statements, and I want to thank both of you very much for coming to be with us this morning.

Our next two witnesses are Michael Ford, owner of Showcase Realty Co., here in West Memphis, president of the West Memphis Realty Association, owner of Mary Jane's Flower Shop; and Don Butler, who is president of the Butler Realty Co., and Butler Homes, West Memphis. Don is a homebuilder; built 42 homes so far this year, and is a realtor for the home he builds. He has 4 to 5 employees and 30 subcontractors. He builds single-family homes. He is president-elect of the Arkansas Home Builders Association. I met him when he was president of the West Memphis Jaycees in 1970. Have you gone up or down since then Don.

Mr. **Butler**. About the same.

Senator **Bumpers**. Thank you both for being here.

Michael, your name is first on my list so why don't you lead off.

STATEMENT OF MICHAEL E. FORD, PRESIDENT, WEST MEMPHIS BOARD OF REALTORS, WEST MEMPHIS, AR

Mr. **Ford**. Thank you.

Good morning. My name is Michael E. Ford. I want to thank Senator Bumpers and his colleagues for inviting me to give my views on this particular tax proposal.

I am president of the West Memphis Board of Realtors, a partner in Showcase Realty, a nonincorporated business, and a partner in Mary Jane's Flower Shop, an incorporated business. The major point that I would like to make is that in whatever final stage the new tax reforms end up in, we must not take away the incentive for people to invest in our economy.

One positive point: As you know, the majority of small businesses are unincorporated. In my opinion, the reduction in the tax rates for individuals will be a great help to the small, unincorporated businesses, such as my real estate company, since most report their business income on their personal tax returns.

Second, repeal of the bad debt reserve. In owning a small retail business, May Jane Flower Shop, this means my business now will be taxed not only on money I have not received but also on money I might not ever receive.

On State tax deduction: On this issue I would like to remind you that most small businesses are not incorporated. Therefore, under the President's proposal, all deductions will be eliminated for state income taxes paid, except on corporate returns. This proposal creates an injustice to all unincorporated businesses.

The last issue I would like to address affects my livelihood. That is, the limitation on deduction of interest. The President's proposal would limit the deduction for interest expense to $5,000 outside your principal residence, other than investment income. I am concerned as a realtor that this provision could inhibit or prevent the sales of real estate for investment. I am further opposed to any modification that would increase the depreciation schedule concerning real estate.

In closing there are many other issues that could be discussed today, but time does not permit me. The tax reform proposal could have a negative impact upon the real estate industry, because the tax benefits from investing in real estate would be reduced.

Thank you for the opportunity to present my views on some of the provisions of the President's tax reform proposal which will have a great impact on my business. It is my opinion that with the loss of investment tax credit, and other cutbacks in incentive to business, small businesses will be hurt and the economic growth of our country will be curtailed.

Thank you.

Senator **Bumpers**. Thank you, Michael.

Don.

STATEMENT OF DON BUTLER, PRESIDENT-ELECT, ARKANSAS HOME BUILDERS ASSOCIATION, LITTLE ROCK, AR

Mr. BUTLER. Thank you, Senator.

My name is Don Butler and it is an honor to appear before you today as the president-elect of the Arkansas Home Builders Association. I represent the more than 1,200 member firms of our association located throughout the State of Arkansans. I am a builder and developer of single-family houses, and I engage in real estate also in Crittenden County area here.

Senator, I wish to commend you for holding these hearings on the President's tax reform proposals, and I appreciate the opportunity to testify. Hearings such as this are necessary because if comprehensive tax reform is to be enacted, Congress should first explore all of the ramifications that such legislation could have on our economy.

The Federal Government long as been committed to encouraging housing and has used tax policy as a significant and conscious instrument of Federal policy to attain housing goals. It is in this context that I would like to briefly touch on several areas of concern to our industry from both the single and multifamily perspectives.

The first one will be the single-family side. Several important tax incentives have been established for owner-occupied housing. These include the mortgage interest deduction, the deduction for real estate taxes, the deferral of capital gains on the sale of a home, and the one-time exclusion for capital gains of up to $125,000 on the sale of a personal residence for individuals who are 55 years old or over. Of all tax deductions allowed by the present law, the mortgage interest deduction probably has the highest level of appeal to middle-class Americans. These deductions make home ownership affordable for many Arkansans.

However, in the scenario of fluctuating interest rates and general uncertainty that has marked mortgage finance in the last decade, the major home mortgage innovation that has helped to address the problem to the greatest extent is the tax-exempt revenue bond. Mortgage revenue bonds make housing more affordable by allowing State and local housing finance agencies to convert tax-exempt funds borrowed at low interest rates into mortgages that are typically 2 percentage points or more below the conventional mortgage rate. Approximately 10,000 low- and moderate-income Arkansas families have been housed through the single-family mortgage revenue bond programs since the inception of this program in our State in 1977. The recently announced single family bond issue, done by the Arkansas Development Finance Authority in the amount of $158 million at a rate of 9.5 percent, is typical of the impact that this concept can have, not only on the residential construction and sales industry in Arkansas, but on our overall State economy as well. It is estimated that about 4,000 homes will be financed with the proceeds of this bond sale, in both fixed-rate conventional and FHA-insured mortgages.

While we are pleased that the President's proposal has retained the full deduction of interest payments on principal residences, we are extremely dismayed that he has proposed repeal of mortgage revenue bonds because they have been an effective means of providing affordable financing to households who otherwise would be unable to achieve home ownership due to continuing high interest rates. In fact, home ownership among young families has been on the decline for the last 5 years. Since 1980, there has been a 5 percent decline in home ownership for families with heads of household aged 30 to 35 years of age. With a HUD-estimated statewide median family income in Arkansas of $19,795 per year, there is no question that removal of the mortgage revenue bond tool will work a considerable hardship on prospective new home buyers in our State by eliminating many of them from the marketplace. Equally as devastating will be the general economic impacts that Arkansas could easily experience if my industry is left without the use of this home financing concept. It is estimated that the total amount of economic activity generated by the construction of 1,000 single-family homes is more than $110 million. This estimate includes not only direct wages, purchases and profit associated with construction of the homes, but also the additional impact caused by the people taking the money received directly from the home building process and spending it in other sectors of the economy. One thousand new homes will generate 1,759 new jobs; generate $7.4 million in tax revenue at all levels of government; and result in untold spinoff purchases that result from the construction of a new house such as furniture, draperies, garden materials, and the many other items used to furnish a new home.

On the multifamily housing side of the issue, tax incentives attracting investment capital have been the lifeblood of the multifamily housing market that serves one-third of all American households, including the poor who cannot afford their own home. Without tax incentives to encourage the private sector to build rental housing, the Federal Government's obligation to assist low-income Americans in obtaining housing would have to be far greater than it is today.

We believe that proposed changes in the current tax rules would severely disadvantage investment in multifamily housing compared to other types of investment alternatives. The history of the recent tax legislation affecting residential structures has shown a progressive reduction of the tax benefits associated with this type of investment. The requirement that construction period interest and taxes be capitalized was enacted in 1976. That provision requires that construction period interest and taxes either be added to the basis of property or be amortized over a 10-year period. Residential real estate also does not enjoy the advantage of the investment tax credit, except in the case of rehabilitation of historic structures. In addition, the alternative minimum tax often affects capital gains associated with real estate investments more than it affects investments in other types of assets, particularly corporate equities or bonds. Finally, the Deficit Reduction Act of 1984 (known as DEFRA) has a significant impact upon investments in real estate. Several of the significant items in DEFRA affecting real estate investments were provisions that increased the recovery period for real estate from 15 to 18 years. That's limited deduction of startup costs for new ventures, expanded the rules relating to amortization of construction period interest and taxes, and restricted the issuance and use of industrial development bonds. Unfortunately, the multifamily housing industry has already had more than its reasonable share of tax reform.

For this segment of the housing industry, the immediate impact of the enactment of the President's proposals would be a substantial downturn in construction and a devaluation of existing rental properties, perhaps as much as 20 percent. This drop in construction reflects the fact that most new projects would no longer be economically feasible. Our national affiliate, the National Association of Home Builders, estimates that for a typical new conventionally financed project to be economically feasible, rents would have to be from 21 to 28 percent higher under the President's proposals. The loss of IDB financing for moderate-income projects would require even larger rent increases.

In summary, we strongly believe that the following principles should guide any major rewrite of the Nation's tax laws:

First, tax reform should enhance economic growth, savings, and investments, not retard them.

Second, tax reform should be revenue neutral or revenue positive, certainly not creating a revenue loss which only adds to the Federal deficit.

Third, tax reform should be fair and not disproportionately affect one industry or group of individuals at the expense of another.

Fourth and final, tax reform should not erode the national commitment to homeownership and affordable rental housing.

In closing, Senator, I would like to note that although some have referred to those who have not fully embraced the President's tax program as "special interests," we believe that housing is more than a special interest; it is a national interest and an important national priority, and that same priority exists here in Arkansas.

I thank you for this opportunity to testify here.

Senator **Bumpers**. Don, let me ask you and Michael both the same question I have asked the preceding witnesses, and I probably know the answer. If you had to choose between the current tax law and the President's tax reform proposal right now, which would you choose?

Mr. **Butler**. Well, of course, the Home Builders Association believes probably in tax reform per se. We want to get interest rates down. We want the Government out of the private money market. We want to get the deficits down. To do that we understand there will have to be more revenue in the Government; but whenever you take away our deductions, and so forth, causing people not to be able to purchase houses and on the multifamily side whenever you take away the deductions from that owner, he's going to have to come up with money somewhere because he's going to raise the rents. These folks are not going to be able to pay higher rents. It's going to offset whatever chart you have here. So I believe in its present form, the current tax would be more advantageous to us than the new proposals. But we would like to see something better than what he's come up with.

Senator **Bumpers**. Michael, do you want to comment on that?

Mr. **Ford**. Senator Bumpers, I feel there is a great need for some form of a tax reform, but as I understand it, I would have to go along with our current tax structure versus what the President has proposed.

Senator **BUMPERS**. How does the President's proposal to raise business taxes and use the increase to lower personal taxes strike you?

Mr. **FORD**. Well, I guess it hits me twofold because, like I said earlier, I have one business that is incorporated and one that is not incorporated. So in one form it benefits me, and in another form it sort of takes it right back. So I don't really know how to answer the question.

Senator **BUMPERS**. Michael, you had something in your statement that I didn't know before, and that is, unless you are incorporated you're not allowed to deduct State and local taxes.

Mr. **FORD**. I understand that that is what the President is proposing.

Senator **BUMPERS**. That's right. That's part of the proposal that I didn't understand. Now I have been opposed to and will continue to oppose the President's efforts to eliminate the deductibility of State and local taxes. I think that's very dangerous. I think it strikes right at the heart of federalism and particularly at a time when we are shifting more and more burdens back to State and local government. We have taken revenue sharing away from them, and we're putting more of the so-called social responsibility for Medicaid and things like that back on the States, and then we're saying, "If you try to raise taxes to pay for those services, we are not going to allow your people to deduct State and local taxes."

We are 47th in per capita income in Arkansas, but we are 39th in tax efforts. So it really hits us harder than it does a lot of States. Now Alaska—it's hard to be all that sympathetic with Alaska. They are the No. 1 by far in per capita income and just about 50th in tax effort. They are violently opposed to this State and local tax effort proposal of the President, and I am pretty much, too.

Let me ask Don. You probably covered this in your statement, but let me make sure of the record. What do you think, if you eliminate the ability to deduct the interest on these mortgage bonds, how much do you think that would raise the interest rate on those bonds?

Mr. **BUTLER**. Well——

Senator **BUMPERS**. Does the National Home Builders have any statistics on that?

Mr. **BUTLER**. Yes; it does, Senator. If you take away all the incentive of the mortgage revenue bond, take away the interest, it's a 2-percent add-on on revenue mortgage bond, plus if you take away the tax incentives, like you're talking about the State and local taxes, the interest, and so forth, I think all of it together is another 1.5 percent on the mortgage. If you have a 12-percent mortgage and you take away the tax incentive, they're going to wind up with 13½ percent.

Senator **BUMPERS**. Well, compared to the 9½ percent now, what does that do to a payment on a $40,000 home?

Mr. **BUTLER**. You can figure somewhere around $10 per thousand. A $40,000 home would be somewhere in the neighborhood of $4,000 or maybe a little less—principal, interest, taxes, and insurance.

Senator **BUMPERS**. Now wait a minute.

Mr. **FORD**. If I could, last night I was writing a contract on a $45,000 house. We were looking at the interest rate at 11½ percent, which is the current FHA and VA rate, versus the 9½ State bond issue we have. It made right at $100 difference in the monthly house payment on a $45,000 mortgage. So maybe that will help you.

Senator **Bumpers**. What was the payment at 9½ percent?

Mr. **Ford**. At 9½ it's $384 a month versus $450-some-odd a month at 11½.

Senator **Bumpers**. How many buyers in your business does that eliminate?

Mr. **Ford**. I'm not sure what the numbers are.

Senator **Bumpers**. Does that make a big difference to a lot of people?

Mr. **Ford**. Yes, it does. Most first-time home buyers are buying at their very limit at what they can afford. If you drop the rate from 11½ to 9½, you just open the door for thousands more people who can afford to buy a home.

Senator **Bumpers**. Let me ask you this—and I'm being the devil's advocate and taking the President's position. He argues that everybody is clinging to these not-so-little deductions that we enjoy like interest on mortgage bonds, investment tax credit, accelerated depreciation. The list is endless of the preferences that people have, and he's saying everybody wants to hang onto those but they are forgetting that he's reducing the top rate from 50 percent to 35 percent. And somebody in a low income, for example, would probably be in the 15 to 25 percent range; whereas now they are probably in the 20 to 40 percent range. He says people are overlooking the fact that he's cutting the rates in exchange for this.

Mr. **Butler**. We feel like he's cutting the rates for the wrong step on the ladder. The middle-income people seem to be bearing more of the brunt of this thing for years and years. The low-income people it will help a little bit on tax reform, but they are going to be eaten up with higher rents because people are going to have to come up with some way to justify the tax money they have lost.

As far as the upper end, most folks—of course, this is my own opinion. They have never paid their fair share of taxes. It's me and Michael here that's been paying them.

Senator **Bumpers**. Michael, in your business what kind of an income does a family normally have to have in order to afford a $400 payment?

Mr. **Ford**. In order to afford a $400 payment, they would need a gross income of between $20,000 and $25,000.

Mr. **Butler**. Twenty-eight percent of your monthly income.

Senator **Bumpers**. Is that what you figure: 28 percent of your monthly income?

Mr. **Ford**. Twenty-eight percent of your monthly income.

Senator **Bumpers**. You include both incomes on a two-wage earner family?

Mr. **Ford**. Yes, sir.

Senator **Bumpers**. So if it's $500 a month, that's $6,000 a year. That represents—let's see, 28 percent. That would be between $20,000 and $25,000 a year, wouldn't it, if you're talking about 28 percent?

Mr. **Ford**. I believe that's correct, yes.

Senator BUMPERS. In any event, you eliminate all those people on a $100 difference. Say $400 to $500 you eliminate all those people whose income doesn't equal 28 percent of the annual payment; is that correct?

Mr. FORD. When you are figuring the payment, you also have to take into consideration the other bills that they might owe, the other obligations such as a car to get back and forth to work with. In our economy today, most car payments range about $300 a month, so that's something else you have to consider.

Senator BUMPERS. On the interest deduction just for the record we need to say this. Michael, let me ask you a question. Now the President's proposal is you can deduct all the interest on your principal residence and an additional $5,000 of nonbusiness interest, plus any interest expense that you offset against interest income. Is that correctly stated?

Mr. LUDLAM. Yes.

Senator BUMPERS. So if you had $10,000 in interest—let's make it more reasonable. If you had $1,000 in interest income from a CD, you could deduct all the interest on your personal residence, your principal residence, plus $6,000; $5,000 for everybody plus $1,000 to offset the $1,000 interest income.

Now, what effect does that provision, if any, have on your business?

Mr. FORD. Probably my personal business it probably doesn't have any effect; but in my real estate business——

Senator BUMPERS. I'm talking about your real estate business. How does it affect the sale of homes?

Mr. FORD. It will affect the sale of homes to investors: people who have the money to invest in our economy, to go out and buy homes to provide rental units for those people who cannot afford homes. If it does not create a tax incentive for them to invest, then what reason do they have to invest? So I think it would greatly affect the investments.

Senator BUMPERS. Let me say as a builder, you can deduct all the interest you want to as a business expense. We are not talking about that.

Mr. FORD. As a builder. But what about as an investor that goes out and buys property that's already built?

Senator BUMPERS. I think if he were regularly engaged in the business of investing in property, that would still be deductible, wouldn't it, Chuck? We're talking about an investor who buys real estate, particularly residences or apartment buildings, and so on. If he's regularly engaged in that business he could deduct all the interest, couldn't he?

Mr. LUDLAM. As a business expense?

Senator BUMPERS. As a business expense, yes.

Now, if he had a second home, he would be limited to $5,000, plus whatever interest income he had.

Mr. BUTLER. From stocks, and bonds, and things of that nature.

Senator BUMPERS. Well, getting back. I will just make one other point here, and that is that one of the points you made, Michael, which I said a moment ago was new to me and that was this idea that you couldn't deduct State and local taxes unless you are incorporated makes no sense to me. That just forces everybody to incorporate.

Mr. **Ford**. Right.

Senator **Bumpers**. I'm quite sure that will be changed before that bill gets out of the Finance Committee if, in fact, it does.

Let me say one final thing. My office is next to the Finance Committee, and they are holding hearings every day on this bill, and those $500-an-hour lobbyists are so thick out in the hall I can't walk down the hall to vote. I told Bob Dole I was going to start holding fundraisers out in the hall. That crowd can afford to contribute.

He said the other day that everbody is for tax reform, but—and the buts are winning. So I wouldn't assess the chances of the tax reform coming out of this Congress more than 50–50 right now, and that may be healthy.

Mr. **Butler**. I would just like to say before we leave that when you were Governor you conceived the idea of the mortgage revenue bond. With the latest issue that we have just come out with, it's $175 million, which $150 some-odd million of it was fundable, that means that we have in new tax revenue in the State of Arkansas in the next 8 to 9 months $2.6 million in new taxes.

Senator **Bumpers**. In State taxes to the State, or to the Federal Government?

Mr. **Butler**. Right.

Senator **Bumpers**. That's pretty impressive.

Mr. **Butler**. We have 7,000 new jobs to come from this. That has to offset whatever the President—he's wanting to deduct. We want to compare these savings and what these new guys are going to be paying in tax revenue versus what he thinks he's going to be saving.

Senator **Bumpers**. That's an excellent point, Don.

Thank you both very much for being with us. You both had great statements.

Our next panel is Sharon Brown, owner of Brown's Grocery Store in West Memphis. Are Larry Flowers and Harvey Turner not here?

Well, Sharon, we're sure glad you showed up. Go ahead with your statement. Welcome. We are glad to have you.

STATEMENT OF SHARON BROWN, OWNER, BROWN'S GROCERY STORE, WEST MEMPHIS, AR

Ms. **Brown**. Thank you, Senator Bumpters.

First, I would like to say in reference to God Almighty I would like to thank him for my presence here today and for Senator Bumpers and his comittee.

Senator **Bumpers**. You are not putting me in that same category, are you, Sharon?

Ms. **Brown**. I hope not.

First, I would like to say that my opinion of the President's tax reform is that I would like for all the taxes to be kept very simple and in lay terms. I am a homemaker; I have four small kids. I did complete the 12th grade, but with no college background I have to employ a bookkeeper in order to keep everything in order for my tax records.

I was once watching this movie and it was about this simple housewife and homemaker. She was asked to appear on this committee in order to help. She said she was not qualified to give her opinion about tuna nor her opinion on how to sell the tuna. The president of the company turned to her and asked her did she eat tuna? She said yes. He told her, "Then you're qualified." I am saying in very simple terms I don't feel qualified, but because I pay taxes I am qualified.

The tax reform I do agree that for the short time I have been in business that I'm in favor of the current tax laws; that they should stay that way. And some of the President's proposals, I know, are affecting unincorporated businesses which may cause a lot of effects that you may not see just right off. But eventually I believe it would cause a lot of problems and difficulties for small business persons. And for just the short time that I have been in business, it's been very important to me in order to keep all the books and all the expenses that I can deduct off the business and when it comes down to my personal, I know that it will be that I can deduct these things off my personal income taxes.

So those are the words. I told you I would be very short.

Senator **Bumpers**. Sharon, first of all for the record, your husband died last September?

Ms. **Brown**. Correct.

Senator **Bumpers**. And you went into this business. You have four children at home?

Ms. **Brown**. That's correct.

Senator **Bumpers**. You went into this business to support four children after he died?

Ms. **Brown**. That's correct.

Senator **Bumpers**. You opened your business in March 1985?

Ms. **Brown**. Right.

Senator **Bumpers**. And this is your first business venture and your first job?

Ms. **Brown**. That is correct.

Senator **Bumpers**. You have a high school education?

Ms. **Brown**. True.

Senator **Bumpers**. And you are not incorporated.

Ms. **Brown**. That's true.

Senator **Bumpers**. Do you have any employees in the business with you?

Ms. **Brown**. Only one.

Senator **Bumpers**. You and one person.

Ms. **Brown**. Right. And now the store is open from 7:30 to 10 and it takes a lot of hours. We have the big grocery stores, take Gene Stimson, for example, maybe run $5 purchase or $10, $15 you get something free; but with a small business you're not able to when you first start out to go to giving away free to the whole community. And being in business just recently since March is being a new venture, but it is my first job.

Senator **Bumpers**. How big an inventory do you have?

Ms. **Brown**. Right now anywhere from $8 to $12,000.

Senator **Bumpers**. Did you borrow the money to go in business?

Ms. **Brown**. No, I didn't.

Senator **Bumpers**. Are you profitable yet? Are you making money yet?

Ms. **Brown**. Right now I'm just beginning to show a profit. Just beginning.

Senator **Bumpers**. Do you keep your own books?

Ms. **Brown**. No, Lucille Pate, a local real estate person and secretary.

Senator **Bumpers**. Now, Sharon, the point was made here earlier this morning that the big business all started out as small business.

Ms. **Brown**. True.

Senator **Bumpers**. And that is the reason we promote small business. A lot of people wanted to abolish the Small Business Administration. I'm ranking member on the Small Business Committee, here this morning in that capacity, and I never though everything about the Small Business Administration was good, but I though a lot of it was good. We have eliminated what we call the "direct loan program" except for minority businesses, handicapped persons, and veterans, and we have gone exclusively to the guaranteed loan program in that business.

There are some people that have good ideas and can make it, but they simple cannot get a bank to believe that. Often times the Small Business Administration will make a loan to somebody that cannot get it anyplace else. I can name you 10 companies, incidentally, that have had small business loans since 1974: Digital Switch, Apple Computer, Federal Express—fairly important in Memphis. There are 10 companies, but those 3 are fairly well known, that pay over $200 million a year in Federal taxes, and they started off with small business loans.

So I can't tell you how much I admire you for taking off on your own trying to support those four children. You have my total admiration and respect for that. And I wish you the very best.

Right now you don't have any tax problems. I can tell that.

Ms. **Brown**. Right now I don't. Thank you.

Senator **Bumpers**. But I hope that when I come back here maybe next year or the following year or whenever I get a chance to stop by and see your store, and I hope you're a big taxpayer by then.

Ms. **Brown**. Well, please do come by, and I do hope in the near future—as you just stated, seems like the small business is such a hard—I imagine if circumstances hadn't happened to me the way that it did, it would have been a problem for me to go, like you say, and take a loan out from other sources such as maybe a bank or different places. They just don't have the trust, as you say, in people who are trying. There are a lot of people who just—money is the main problem. They don't have it. And if they had the money to back them, it would be a lot more business, a lot more jobs and a lot more opportunities, and a lot more technical ideas being put into action and not just in somebody's head.

Senator **Bumpers**. Sharon, I prefer tax laws that not only encourage people like you to do things like this: go into business for themselves, but to give you a fighting chance. You know, the Krogers and the Safeways and all those people, they can take care of themselves. It isn't that I don't worry about them. They have legitimate concerns, too. But I don't want them to be able to take unfair advantage of small businesses like you. I do want to promote and encourage people like you to do exactly what you are doing.

I wish you the very best. If I can ever be of help to you, I would be glad to hear from you.

Thank you, Sharon.

Our next panel is Dick Hatfield, a tax attorney with the firm of Hatfield, Hodges, Marshall & Jordan. Dick is also president-elect of the Arkansas Bar Association and past president of the Searcy Chamber of Commerce; has a lot of small business clients. Harry F. "Pat" Dodge, CPA of Dodge, Thomas & Goss in West Memphis, Past President of the Arkansas CPA's and his practice is focused on small business. Don Brawley is owner of Don Brawley Insurance here in West Memphis. Has one other employee and had been in business for some 15 years.

Welcome to all you gentlemen. We are going to get into something a little different from what we have been talking about in the past, I assume.

Dick, since your name is first on my list, why don't you start off.

STATEMENT OF DICK HATFIELD, TAX ATTORNEY, HATFIELD, HODGES, MARSHALL & JORDAN, WEST MEMPHIS, AR

Mr. **Hatfield.** Thank you, Senator Bumpers.

Again, as with other witnesses, I appreciate the chance to come and put in my nickel's worth. I'm a lawyer; practice here in West Memphis and practice in Searcy and Little Rock. Been in a four-man firm and been in firms from one to five people. My practice has been basically representing small businessmen and farmers in tax, estate planning, and corporate matters. And by "corporate matters" I don't mean Kroger and that sort of situation.

My view would be, as I see the tax reform bill as it's called this year, we have had enough of them. But how it affects what I see as the dealings I have had with small business people with the view that the tax law has got to raise revenue fairly simply and encourage economic growth. That's my understanding of the tax law.

Now in advising my clients—in considering the tax bills and advising my clients, the first problem I have had—of course, any advice I give them they have to pay for and that costs them money they could be putting in jobs and capital, and that sort of thing. They don't like to come see me any more than necessary. I think going to see a lawyer is in some respects like going to the dentist: anybody that likes to go there is crazy. But it's a necessity sometimes.

The 1976 Reform Act, the 1978 act, 1981, 1984, and here we are in 1985 with another act. This is a problem for the small businessmen because he can't predict what he should do. By "he" I don't mean to be sexist in this. Businesswomen and businessmen are on equal footing in my view, but just for the purpose of simplicity I'm going to keep it to a businessman.

A businessman in order to decide whether to go into business or whether to progress or grow or what action to take has got to depend, in some respects, on the tax law. He's got to come to a CPA or tax lawyer to help advise him in that regard. The least that happens, I think the better off. There's an absence of predictability. This discourages economic growth. Another aspect that I see is the cost of administration.

Fairness and simplicitly are two concepts. I think for the small businessman if the tax law is fair but it costs so much to administer, it's not fair because he can't compete with Kroger or Safeway. A cost of administering the tax law or complying with it is important to the businessman. To me, it's important to the service because with some of these proposals the service is not going to have the manpower to police them so what difference does it make? That is a problem, too, as I see it.

Now it seems to me that the small business should be encouraged to grow in our economy because it's the American dream. You've got a chance to have a piece of America, hope, better yourself. I know I had that hope when I started practicing law, and it should be the same for every American. That is, a real chance to be a part of America, to provide the things for your family that you want, and in doing so you can provide for others.

You take Sam Walton; started out in Newport years ago. Well, he started out the same way a lot of people do—the same way a lot of people in this room have—and if the Government tax program encourages that person to get into business and grow, then that's better and it creates jobs. It's better for everybody. I think for a businessman who makes a million dollars in his business, he's probably created job opportunities for many others and has helped our system. So, I think it's important to encourage small business because it's part of America.

Now, in regard to those concepts, I'd just like to comment briefly one some of the issues brought out in the new tax bill. With regard to rates: Corporate rates need to be low, I think, because in advising clients that are starting businesses or who are in businesses the only way to build capital under the current tax law, I think, is to incorporate your business. If I start a business, whether it's a hardware store or a law firm or whatever, I've got to make enough money to live on and pay the taxes. What's left goes into the business. With the tax structure like it is now, I've got to incorporate my business as a practical matter to build the capital to have more jobs and to grow. The corporate tax structure needs to be such that it's at the low level.

Long-term capital gains, I think, need to be favored because this is venture capital. I see a lot of people who will invest in small businesses with the hope that a few years from now they will be able to take the benefit of capital gains. Well, this encourages finance, business venture. I have some clients now from Holland, and they are investing in a business in Searcy. One reason they are doing so is they think there will be a good rate of return and they are concerned about the tax law and using capital gains. This encourages people to start businesses and encourages people not involved in the business to invest in it.

Depreciation, I think, has gotten too complicated to administer in the sense that a small businessman can't worry about indexing and all that stuff. The small businessman needs to be able to tell where he is and not have to hire a bunch of lawyers and accountants to tell him what his situation is. The more complex the depreciation, the more complex that problem is.

ITC, investment tax credit, the same way. Investment tax credits lower the cost of acquiring certain assets. It discriminates probably with regard to capital intensive businesses as compared to labor intensive, but to me in dealing with—investment tax credit from my standpoint as a businessman or from advice basically can help a marginal or good deal better, but it can't make a bad deal good. We have seen that in tax shelters. It can't make a bad deal good. So your first principle is: Is it good economically for my business? But that investment tax credit—I think it acts as an incentive and that money basically stays in the business to grow. Employee benefits should be comparable for small businesses as well as large, so small businesses can attract employees just like the larger businesses can.

You have other matters. For instance, another problem in terms of compliance with the tax law is payroll taxes. I mention this as a small matter, but we have a heck of a time in our office with payroll taxes. I would suggest that this, along with investment tax credit and basic tax law, as it applies to small business, be simplified in terms of administration. You can raise thresholds about how often you deposit money. Your payroll taxes, that can be a real problem. It's a problem that takes away from running the business.

The last area I would like to address briefly is cash method of accounting. It seems to me that there is no real purpose achieved by changing the cash method. Changing those who are reporting tax on a cash method as compared to an accrual method. First of all, there's a $5 million limit. Once the concept is in the code, as so many times happens, once it comes out everybody has to comply. There are no limits. This is a good example of simplicity versus fairness. Maybe in terms of overall policy it would be better to have everybody on one accounting system, but for the small businessman you ought to pay your tax when you collect your money. That's not true of an accrual accounting system. It's going to cause unnecessary administrative expense for anybody who has to change over. The Government is going to get their money. We're talking about which tax period you pay it in. If you do away with bad debt reserve, you have people spending time worrying about how to adjust their billings instead of operating the business. I don't think in the overall run that the expense for the taxpayer to comply or for the Service to make them comply will be worth the additional revenue. The Service can't police what they have now. How are they going to police something like this? I think that's a problem.

Now, I would just like to conclude by saying that the basic theory of the tax policy should be in terms of simplicity and fairness. You get a threshold. I think the standard deduction is a good idea. It was a good basic rule. A lot of people need to be worried about keeping their interest expense and medical deductions. Raise the threshold and don't worry—basically be fair up to a certain level, but worry about simplicity. Over a certain level the people that are involved in that should have enough resources to pay lawyers and accountants. But those people—and this applies certainly to small businessmen whether you're talking about depreciation or employee benefits. I think it would be in the interest of our national policy to encourage lower costs for the small businessman, let that person put his money into growing, and then when he get to the level where you are worried more about fairness because the cost justified it, then he can afford it. But before then, I think that basically simplicity should be the rule.

Thank you.

Senator **Bumpers** Dick, that's an excellent statement. I appreciate that. We will get to some questions in a moment.

Pat.

STATEMENT OF HARRY F. DODGE, CERTIFIED PUBLIC ACCOUNTANT, DODGE, THOMAS & GOSS, WEST MEMPHIS, AR

Mr. **Dodge.** My name is Harry F. Dodge. Most people call me Pat. I'm a practicing CPA, having established my office here in 1958. Prior to that I was with CPA firms in Memphis for approximately 9 years. I practice now with my partners, Ken Thomas and Bob Goss.

I appreciate the opportunity to express my views here this morning, and I'm pleased to know that our Congressmen in Washington are concerned with the thoughts and opinions of those of us out in the hinterlands. When Chuck Ludlam asked me what subjects I might wish to comment on, I told him that the three items Senator Bumpers had singled out were of interest to all of us, and I certainly had an opinion on all of them.

After due consideration, however, I'm going to throw Chuck a curve and talk about something else entirely. My main concern, as it appears to be the other's, is the matter of overlegislation. We have had four major tax bills since 1978. Our legislators discuss a piece of tax legislation. They decide it will bring about such and such a result. They pass in into law. But before it's been long enough to have any effect, they change it. So we never know whether it would have worked or not.

I used to think that the major life insurance companies were going to end up owning this country. Now it appears that we will be owned by Commerce Clearing House, Prentice-Hall, and Research Institute. They are the three major publishing companies, and they are really thriving on all this. We used to spend a few hundred dollars on tax services, and now it's thousands and we don't have time to read it.

Not only do we have too much legislation in the field; we have entirely too much gimmickry. Most of these gimmicks are designed to bring about social change or to benefit or punish a certain group of taxpayers. Many times it seems that the collection of taxes is secondary. But back to the gimmicks. When I began my career back in 1949 the tax rules insofar as business was concerned pretty much squared with generally accepted accounting principles. That's known as GAAP in the trade.

Now admittedly GAAP has gotten kind of far out over the last few years, but it's still based on reason and not gimmicks. I might also add that the American Institute of CPA's has labored long and hard trying to find a way to relieve CPA's who are concerned with small business only from the need to apply the same expensive and time-consuming procedures which are required by the Fortune 500.

Over the years what should be a simple thing like depreciation of fixed properties has developed into a nightmare. The present ACRS method required by the Treasury is not in accordance with GAAP. Consequently, if the client needs a financial statement to presented to a bank or some other institution, a separate depreciation schedule must be set up and maintained. Now they propose to change to yet another system that doesn't square with GAAP. It also doesn't square with the methods required by the State of Arkansas. They finally accepted ACRS. So now we have the possibility of three separate depreciation schedules. We have clients who have 15 or 20 large pages of depreciable property. This is just money down the drain.

Another gimmick is the expensing of assets up to $5,000. That's off the books. Of course, when you take your balance sheet to the bank you'd like to have that $5,000 on your balance sheet.

Indexing tax rates is certainly desirable to avoid tax increases due to bracket creep; but when we begin trying to index inventories, depreciable property, the basis for computing capital gains, we are headed for more and more complications. Frankly, I haven't seen a proposed provision yet that will really do anything toward simplification. To the contrary, everthing points to further complication and more recordkeeping.

Actually, if the present trend continues, the small business will have to keep two complete sets of books: one based on historic costs and generally accepted accounting principles in order to know what the business is actually doing, and another for tax purposes. They tell me some folks do that anyhow, and not for that reason.

If the Congress really wants to do something for the small businessman, let's repeal the latest rules on original issue discount. They are impossible to comply with in the first place. Also, let's go back to the historic situation of being able to accrue salaries and bonuses and year-end expenses if you are on the accrual basis. Most small businesses don't have good enough records to know how to do all these things before the year end. The big fellows that have qualified accountants on their staff have good enough records to where they can take advantage of it, but the little fellow can't. And we don't have time to be there at year-end for all of them.

I guess it's time just to yell calf rope. If the pointey-headed people in the Treasury who think up all this can't think of any way to simplify the situation, at least give us some relief from the constant change.

Thank you.

Senator **BUMPERS**. Thank you, Pat.

Don.

STATEMENT OF DON W. BRAWLEY, SPECIAL AGENT, PRUDENTIAL INSURANCE CO., WEST MEMPHIS, AR

Mr. **BRAWLEY**. My name is Don Brawley and I am a special agent with the Prudential Insurance Co. My title, special agent, means that I am an independent contractor, thus an independent small businessman.

Senator, the importance of your committee and the appropriateness of these field hearings cannot be overestimated, because small business is really the cornerstone of our American business community. According to the Small Business Administration, the 14.3 million small businesses comprise 98 percent of all businesses in the country. That is correct. In the United States 98 out of every 100 businesses are considered small businesses. One-half of the private employment in the country is accomplished by small businesses. The Department of Labor reports this week that over 53 million Americans will receive their paychecks from small businesses. These statistics point out emphatically that the impact of tax changes on small business are, and should be, a major concern, and I commend you for conducting these field hearings.

Since my firm markets life and group insurance primarily to small businesses, there are two areas of the President's tax reform proposal about which I am most concerned: the proposed taxation of the inside buildup of the cash values of life policies; the taxation of fringe benefits, specifically health insurance.

Small businesses use life insurance in a number of ways: funding buy and sell agreements, providing key man coverage, and covering lines of credit are just a few. Many businesses were started using life insurance policies as collateral for loans. In 1983 an estimated 30 percent of the $7 billion of permanent life insurance death benefits was paid to small businesses and family farms. That percentage translates to about $2.1 billion in that one year.

Since the inception of the Federal income tax, life insurance policyholders have not been taxed on the unrealized increase in the value of their policies. Under the administration's proposal, life insurance policyholders would have to include as interest income for the taxable year any increase in the amount by which their policy's cash surrender value exceeds the basis in their contract. The proposal applies to all forms of cash value life insurance, including universal life and variable life. This proposed tax would impede the social good provided by life insurance and would make it more difficult for Americans to be responsible for the financial security of their families. Many families are self-sufficient and many business doors are open today because life insurance dollars are available.

A life insurance policyholder, like a homeowner, should not be taxed on increased values which have not been realized. It would be a departure from basic tax rules to tax policyholders on amounts they cannot receive unless they give up rights and benefits.

Since the administration's proposal would raise insignificant revenues through 1990 and very likely would not produce significant revenues in the 1990's, the prospective application of the administration's proposal is not an acceptable alternative to current law.

The administration also proposes a new tax on employee health care benefits. Current law permits an employer to deduct contributions to an employee health benefit plan and permits employees to exclude these amounts from their income. Under the administration's proposal, employer contributions to an employee health benefit plan would be included in the employee's gross income up to $10 per month, $120 per year, for an individual; $25 per month, $300 per year, for family coverage.

Enlightened tax policy, coupled with initiative by management and labor, has resulted in comprehensive health care coverage for the great majority or working Americans. Today, over 162 million Americans under age 65 are covered by group health insurance.

There is virtually no logic in terms of either social or tax policy to support the creaton of a tax liability associated with the receipt of employer sponsored health benefits. The new tax, quite frankly, would cause some people to lose coverage. Also, the taxation of health benefits would create an undesirable precedent, leading inevitably to higher levels of tax as the need for Federal revneues increased.

The American people are on record as being against a tax on health care benefits. In a recent Roper survey, 80 percent of the population opposed the taxation of their health benefits as a way to raise tax revenues, even if the purpose was to lower tax rates.

The present tax treatment of employer provided group health insurance has contributed significantly to a sound health care system for American workers. I am opposed to any form of taxation on employer contribution to health benefit plans.

Thank you.

Senator **Bumpers**. Don, thank you very much.

Let me start off by commenting on your statement, and that is, if there is anything I feel reasonably sure of it is that the two issues you raise: Taxation of buildup of cash values and the taxation of employer paid health care benefits, neither one of those parts of this proposal will ever see the light of day. If you are going to tax cash values on life insurance, you're going to eliminate the life insurance industry. Nobody is going to buy life insurance if they are going to have to pay taxes on it because they are not buying it for cash buildup in the first place. They are buying it so their wife and children or husband and children will be protected if anything happens to them. They are buying it to protect them against a terrible risk of dying before they reach their three score and ten or whatever it is.

When it comes to health care, the cost of which is going up every year, to say to an employee that, "You're going to have to start paying taxes on this, you know, $120 a year or $300 a year, whatever it is," that is an absurdity. There is a social and a revenue value both to the Federal Government in encouraging extensive health care coverage and that is: One, you give employers and employees both an incentive to carry extensive coverage; and two, you by doing that eliminate a lot of people who would otherwise be on Medicaid, which is one of the most expensive programs; almost $30 billion a year, the Government pays. So none of that really makes any sense to me. I don't intend to support either one of those proposals, but you put it in wonderful perspective and stated the case, I thought, extremely well.

One thing that happened in Fort Smith yesterday, Dick and Pat, and it's happening here today and it's an interesting thing because it will help me in debating this bill if and when it's ever considered on the floor. I find that among accountants, even more than the business community, their big squawk is that Congress just keeps tinkering with the Tax Code year after year after year and the IRS if forced—I think they overdo it, but they are forced to change the regulations every time we tinker with the law. It prohibits small business and big business, too, for that matter, from doing sensible planning because they don't know from one day to the next what they will be confronted with on the tax laws. It seems to me after 10 years in the Senate what we do is we pass all kinds of business tax laws to encourage economic activity and we wind up tinkering with it because we need more money for the Federal Treasury. So we giveth on the one hand for particular economic purpose and we take away on the other hand for a governmental purpose, and nobody can ever get the two in balance so they just keep annoying people. And it is that, I think, based on these two days of hearings—it is that thing as much as anything else that has caused this eroding confidence in our tax system, this intense cynicism that causes people to not avoid taxes but to evade taxes, and promotes the underground economy in this country which is costing us probably $2 billion a year in revenues.

This may not be a fair question, and if you don't want to comment on it I certainly will understand and wouldn't press it. How extensive do you think tax evasion is today compared to 10 years ago?

Mr. **Dodge**. I think it's pretty extensive. I think the underground economy is very extensive. I notice a couple of years ago when Commissioner Roscoe Egger talked to the American Institute he was asked a question about the underground economy and he sidestepped it beautifully. He talked for 30 minutes and never even mentioned it. So it's a sore spot with the Treasury Department. I don't think any of us knows how much there is. Of course, the only way to try to minimize that is to try to make our tax laws more fair. But sometimes I wonder if there is a fair tax. Regardless of what kind of law we have, we're not going to satisfy everyone. Certainly we can't.

But to get back to your question, I think the underground economy is just ballooning all the time, and it will be much worse if this bill passes because this thing would be impossible to comply with. Simplicity is out of the question.

Senator **Bumpers**. Dick.

Mr. **Hatfield**. I think the accountants who see a person's books annually would be able to give a better—more informed answer. Now I don't mean by this that any of them would be advising their clients to do that, but they've got to rely on what the clients tell them.

Senator **Bumpers**. Dick, incidentally I used to do a little tax law. When I first started practicing law, I'd do a tax return for $5, $7, whatever I could get because I had two or three hungry kids and not a very big law practice. I used to tell those people—occassionally somebody would bring me in a cigar box full of receipts and papers and some figures, and I would tell them, "I'll total this up for you, but I'm not going to sign your return for you." Because you could just see fraud all over it.

Mr. **Hatfield**. Well, it gets back to the point that you mentioned. If the tax law is so complex that you really don't know how to comply with it, are you an evader or an avoider? I think it really gets a lot of times back to the individual. I see this. I see some people that are basically going to take every advantage they can, and I think those are the people who are more likely to be not reporting all their income tax on the returns. But I also know, and in my practice I do some work with tax fraud and I've run into several cases where people have not reported income because of the problems they had in figuring out where it is. So, it is a problem.

I think a better concept of fairness would encourage more people to report fairly, but I think there's the perception that, hey, those big people—the big businessman is deducting these lunches and all that, and why shouldn't I do it? I'm doing the same thing. The people I'm talking about don't think they are cheating the Government. Their perception is, "Hey, I'm going to be treated just like that person is." With regard to entertainment expenses, I don't think I ought to foot the bill for the people in Washington who have to spend three times what I have to for entertainment. I'm sure there's a lobby in Washington opposing that, but I don't think it's fair.

Senator **BUMPERS**. Dick, you know the President is proposing to eliminate the deductibility as a business expense the purchase of sporting events tickets. You are going to see a lot of these million-dollar-a-year athletes take a pretty severe cut in salary if that goes through.

Mr. **DODGE**. Brother Ken is not going to like that.

Senator **BUMPERS**. The Razorbacks and everybody will suffer to some extent if that happens, but professional athletics will really suffer more.

Mr. **HATFIELD**. I guess these things seem to have crept in and they are more expensive now, and I don't know what effect it's got on the overall picture. But I can see a person in a small business who maybe can't buy tickets to a Razorback game and why should somebody who can get to deduct it? Well, I think that is causing—I think they think that's unfair, and therefore if they take a little money out and don't report it, it's just evening things. I'm not saying you ought not to deduct it. That's more of a policy decision.

Senator **BUMPERS**. You know, Pat, you made an interesting observation about fairness and simplicity and I have concluded, of course and I think it's correct, that both fairness and simplicity are like beauty: They are in the eye of the beholder. You will never achieve a perfectly fair tax system. At least you will never achieve one that is perceived to be fair by a significant majority of people.

The point was made a moment ago about seeing wealthy people get by with a lot of things encourages a lot of other people to see if they can't get by with it, too, because they think it's inherently unfair for people, simply because they are wealthy or have a big business, to get by with a lot of things.

The Treasury Department, about 2 weeks ago, released some interesting figures. No. 1, 3,000 people in this country made over $1 million last year and paid no income tax. Thirty thousand people made over a quarter of a million dollars and paid no income tax. So, you see, people infer from that if you're rich, you just don't have to pay taxes.

I was on a talk show in Little Rock, one of those call-in programs a couple of days after that, and I made the statement perhaps we ought to have a minimum personal tax as well as a minimum corporate tax. A guy called in with a very legitimate question. He said, "What if I invest my $10 million in tax-exempt bonds, municipals, at 10 percent and I had $1 million a year income and because that is a preferential item I'm not paying any income tax." And I have a tendency to favor the exemption of municipal bonds. I think State and local governments have a tough time without that exemption.

So, I had to stop and think for a minute, you know, what is my position on that. I don't really know what it is, but I'm still inclined to come down on the side of a minimum personal tax for that person.

Mr. DODGE. There is an alternative minimum tax, and in fact, it will ruin you.

Senator BUMPERS. In that case that person wouldn't have to pay any tax, would they, Pat?

Mr. DODGE. The alternative minimum tax does not deal with municipal interest. Municipal interest is tax free. It's exempt. And, you know, people talk about this thing. If it's good to have the interest paid by municipalities exempt, if it's good to have that exemption, why criticize the large taxpayer who takes advantage of it?

Senator BUMPERS. That's just it. I mentioned General Electric. They simply took advantage of the law as it is. They didn't violate the law.

Mr. DODGE. The point is, by not taxing this we are helping the cities. We all say the cities need the help, and I'm sure the city of West Memphis does. But if we begin to tax this municipal bond interest then the city is going to have a whale of a time selling their bonds, and then where are we?

Senator BUMPERS. How do you feel about the deductibility of State and local taxes?

Mr. DODGE. I think they should be deductible.

Senator BUMPERS. Do you agree with that, Dick?

Mr. HATFIELD. As it stands now from the small business standpoint, it discriminates in favor of the corporate——

Senator BUMPERS. That doesn't make any sense, does it?

Mr. HATFIELD. Not really, but frankly the only way you are going to build capital now is as a corporation because of the progressive rate. You've got so much money coming into the business. You've got to live out of it and pay taxes out of it. What's left, if you aren't incorporated that's going to be taxed at a higher rate and you're going to have less money left. Then you've got the alternative that's creeping up on us that we haven't even talked about, and that's social security. Now that's 14 percent to a corporate business. I can remember doing tax returns when it was a few hundred dollars.

I think they ought to have a deduction for State and local taxes. In Arkansas we have a pretty high income tax, and it would—it's something that's just a cost of doing business, I think. The State is going to be forced to other areas of raising revenue, and if the Federal Government is going to give them less, where is it going to come from?

Senator BUMPERS. Don't you think it's also a form of double taxation?

Mr. HATFIELD. Yeah.

Senator **Bumpers**. If I make $30,000 a year and say I pay $1,000 in State income tax, then I have to turn around and pay Federal tax on that same $1,000, that is simply double taxation, is it not?

Mr. **Hatfeld**. That's correct.

Mr. **Dodge**. Of course, you can get involved with several States also as we are here with Arkansas, Tennessee, and Mississippi right together.

Senator **Bumpers**. Yes.

Mr. **Dodge**. It's conceivable that you could get into a situation where your tax would be darn near as much as your income.

Mr. **Hatifield**. You mentioned that the accountants over at Fort Smith were concerned about this. I've see it, Pat has seen it coming in since the 1969 Reform Act, which is the first one I really started dealing with, and the accountants and attorneys don't like to have to call their clients and say, "We can't tell you what the answer is." They call up and say, "Should I do this? Should I buy this piece of equipment? Should I acquire this business?" We've got to go back and figure out what the law is. They don't like to pay us for that, and it impedes progress.

I think there would be a lot more said for stability and—get some stability. Stability would have more value than tinkering with it periodically.

Senator **Bumpers**. Well, you know, if you had a choice between tax reform, which we will say is revenue neutral in this case, Joint Taxation Committee says this raises the deficit $25 billion over the next 5 years—which, incidentally, is enough to make it objectionable to me. Whatever we do; I'm not going to vote for anything that raises the deficit.

But if you had a choice between a tax reform bill that actually raised revenues and reduced the deficit but one that was a simpler, fairer tax and also raised taxes and helped reduce the deficit and a tax reform bill that was either revenue neutral or one like the President proposed, one that was admittedly fairer and simpler, which would your prefer?

Mr. **Hatfield**. I'd take simplicity. It's like the question you asked one of the first witnesses. Would you stay with what we've got or pass the new bill? Just in the interest of predictability—there's a lot of things I don't know about in terms of the overall revenue impact; but for the small businessman simplicity would add, I think, a great deal.

Senator **Bumpers**. Would you agree with Pat? For example—maybe you did, Dick—one of you mentioned indexation. You start putting indexation on capital gains and indexation on——

Mr. **Dodge**. Inventory.

Senator **Bumpers** [continuing]. Inventories and that sort of thing, you talk about something complicated, that would be a nightmare.

Mr. **Hatfield**. It is just like this imputed interest—this unstated interest. That is a nightmare, and it involves small business people. Basically you take a small business person and they have certain funds available. Sometimes they use them, borrow them from the corporation, or deal in matters where you don't want to charge the full rate of interest for different reasons. I defy people to advise their clients based on that unstated interest. They finally did what I feel is probably the best thing. They put a limit, a threshold.

Below the threshhold, you don't worry about it. Do what you want to do because that's simple and it doesn't require a businessman to call his lawyer or accountant and figure out what he's got to do.

Senator **Bumpers**. On indexation of personal rates, somebody else can establish those rates so you don't have to mess with it. If you just look at the charts and say, "This takes into consideration whatever the CPI increase was last year"——

Mr. **Dodge**. That would be no problem.

Senator **Bumpers**. Incidentally, my objection to indexation on personal rates has not been because it isn't a powerful argument. It's just that we can't afford it. It's a pretty big ticket item over the next 5 years.

Mr. **Dodge**. But it's certainly not fair to raise taxes without raising the rates. Actually, right now inflation is not that large an item.

Senator **Bumpers**. No, it isn't. It was devastating to us in the late seventies.

Mr. **Dodge**. Oh boy. When Cousin Jimmy was in there it would have killed us. Right now I don't see it as a large deal, but still inflation may be down the road and I certainly would like to see that provision in there. As you say, it would not complicate——

Senator **Bumpers**. There isn't any paperwork involved in that.

Mr. **Dodge**. No; one of the things I have heard so many accounts (media) mention is the simplicity involved in cutting down the number of brackets. That's got nothing to do with it. It simplifies nothing.

Senator **Bumpers**. I'm glad to hear you say that. I said, "There ain't no reform in cutting 14 brackets to 3. What's the reform about that?"

Mr. **Dodge**. I personally don't favor a graduated income tax.

Senator **Bumpers**. But if you're going to have a graduated income tax, there's nothing sacred about 3 brackets as opposed to 10. That's been a concern to me, Pat. I'm glad you raised it.

Mr. **Dodge**. It simplifies nothing.

Senator **Bumpers**. You've got a chart there. That's the simplest thing in the world to figure out what your tax rate is.

Mr. **Dodge**. Besides that, the computer does it.

Senator **Bumpers**. We could sit here and have a nice conversation all day.

We have another panel we need to get. Dick, Pat, Don, thank you all very much for being with us.

Joe Dooley is a John Deere equipment dealer from Wynne. Where is Joe?

Joe, come around.

Joe is representing today the Midsouth Farm Equipment Association, particularly on the investment tax credit issue. Joe, welcome. We are glad to have you and I'm glad you could make it.

STATEMENT OF JOE DOOLEY, JOHN DEERE EQUIPMENT DEALER, WYNNE, AR, REPRESENTING THE MIDSOUTH FARM EQUIPMENT ASSOCIATION

Mr. **Dooley**. Thank you, Senator Bumpers. I appreciate the opportunity. I want to reiterate my thanks to you for coming to Arkansas, back home, during this congressional recess. I know you have a large job ahead of you after Labor Day, particularly with this tax reform and the farm business facing you in Congress. So thank you for coming back home and allowing us to participate in this discussion.

Senator BUMPERS. Thank you, Joe.

Mr. DOOLEY. I have some very brief remarks I want to make. Donald McKnight and I both live in Cross County, and I did not know he was coming today, but I feel like——

Senator BUMPERS. That's OK. We don't care where people come from as long as they get here.

Mr. DOOLEY. Donald and his wife, Marjorie, were Farm Family of the Year in Cross County last year. Anyway, our county is well represented today by the McKnights.

The repeal of the investment tax credit in President Reagan's tax reform proposal would have a devastating effect on our farmers, the farm equipment retail business, and the farm equipment manufacturers. Currently if a farmer purchased farm machinery for $50,000 he would be entitled to an investment credit against his income tax of $5,000. The Reagan and U.S. Treasury proposal would not allow any tax credit for farm machinery purchased after January 1, 1986. It is indeed ironic that a tax bill which promises to provide reduction in taxes for almost 80 percent of all individual taxpayers substantially increases the tax liability of our Nation's farmers who can least afford it.

Farm commodities represent a substantial portion of this country's exports, and with an inceasing trade deficit we cannot afford to increase the cost or reduce the efficiency of our Nation's farmers. The repeal of the investment tax credit would have a very detrimental effect on the farm equipment industry, both manufacturing plants, retail farm equipment dealers, and it will increase the cost of the farmers' capital goods, plus the cost of producing farm commodities.

The Midsouth Farm Equipment Association, representing over 400 farmers urges the U.S. Senate, Small Business Committee, to retain investment tax credit for the agricultural industry.

Senator BUMPERS. Joe, thank you very much.

I assume from your statement that some farmers were making enough money they want to take advantage of the investment tax credit.

Mr. DOOLEY. It's been about the only thing in the past that's prompted farmers to purchase machinery, Senator. Our family has been in the farm equipment business 50 years, and it has been one of the best stimulus to our business and, of course, the manufacturers as well, to have a man take 10 percent of the purchase price off the net income amount of his tax bill.

Senator BUMPERS. Joe, do you sell a lot of equipment under an arrangement that a lot of dealers started using back in either 1980 or shortly thereafter, where you lease the equipment to them?

Mr. DOOLEY. Yes, sir.

Senator BUMPERS. And have a balloon on the end—option to purchase on the end, and so on?

Mr. DOOLEY. Yes, sir; yes, sir, and I think if you see the repeal of investment tax credit, your brother's business will flourish. We will all get into the renting and leasing business. There will be a host of tax lawyers and accountants that will figure out a way to get around the law if investment tax credit is repealed. We'll get into the renting and leasing business.

Senator BUMPERS. Now, you are a John Deere dealer, right?

Mr. DOOLEY. Yes, sir.

Senator BUMPERS. I'm not advertising John Deere, but I just——

Mr. DOOLEY. Now, you were a John Deere dealer in Charleston.

Senator BUMPERS. I wasn't in your league, though, Joe. I was a small John Deere dealer. But let me ask you this: In this financing arrangement the Deere company does this, do they not? When you sell something on that lease-purchase basis, that is actually financed by John Deere, is it not?

Mr. DOOLEY. That's correct. Yes.

Senator BUMPERS. But they get that investment tax credit, don't they?

Mr. DOOLEY. That's correct. Yes.

Senator BUMPERS. That's what makes it a bankable deal with this is that they get that investment tax credit.

Mr. DOOLEY. Yes; the farmer gets the deduction on the lease payment.

Senator BUMPERS. He deducts the total amount of his payments, doesn't he?

Mr. DOOLEY. The lease payment, that's correct.

Senator BUMPERS. How much of your equipment do you sell that way? Let me say this: If that's proprietary information, I wouldn't ask you to answer.

Mr. DOOLEY. I would say, probably, 10 percent.

Senator BUMPERS. Very small amount.

Mr. DOOLEY. Very small amount.

Senator BUMPERS. Most people still want to buy outright.

Mr. DOOLEY. Most people want to purchase outright and get the depreciation and the investment tax credit, yes, sir.

Senator BUMPERS. Joe, that's a good statement. Appreciate your coming over to be with us. Wish you would have brought your beautiful wife.

Mr. DOOLEY. Thank you. I want to say one more thing. No one has mentioned in this whole discussion about the feasibility of reducing the defense spending, yet yesterday the Secretary of Defense, Caspar Weinberger, in a very casual press conference said that they were doing away with the Sergeant York-Buck Rogers type tank because they had spent $1.2 billion on it and it wasn't feasible. Now there's two people that should have been fired: The guy that manufactured it and the guy that sold it to the Pentagon. I think it's time that we look—rather than reforming the present tax system—we look at cutting this massive and horrendous defense budget.

Senator BUMPERS. Joe, you get me started on that and we will be here all day long. It's interesting you mentioned that. This morning there were five of us flying over here and we talked about that. In my 10 years in the Senate that is the first weapon system that has ever been killed. Now it ain't the first bad weapon system we ever bought, but it's the first one that's ever been killed. I'm going to have to change my speech because until now I have said, "There's never been a weapon system killed since I have been in the Senate." Did you know that Caspar Weinberger had to kill this one; Congress didn't kill it.

I made a speech on the floor of the Senate during the defense debate in which I pointed out—actually, what he's talking about is what we call the division antiaircraft gun. Divad is what we call it. The Divad gun. To be mounted on a tracked vehicle to shoot down airplanes in combat—infantry-type combat. We have spent over $2 billion on it, Joe, and it ain't ever hit a bull you-know-where yet. and everybody knew that weapon wasn't going to work from the very beginning, and yet Congress kept pouring money into it. We've got an air-to-air missile called AMRAM that we've got over $1 billion in that is never going to work, and Congress put another $100 million in it this year. I hope Caspar Weinberger—since Congress is never going to have the courage to kill a program—will kill that one, too. Then the MX missile in 1981. All the gurus on defense in the Senate, Sam Nunn, Scoop Jackson, John Warner, Bill Cohen, and John Tower, chairman of the Armed Services Committee, said, "Why, to build those MX missiles and put it in those existing silos out West would be the height of insanity." But the President wanted the MX, so what did he do? He couldn't get it, so he appointed a Commission. That's what Presidents always do: Appoint a Commission, when they don't get their way. The Commission came back and said, "Yeah, we ought to build 100 of these." Do you know what the price tag is for 100 of them? $35 billion, $35 billion for a missile that gives us nothing.

So, those same people still on the floor said, "Well, you know, maybe we ought to have at least 100 of them." The same people who called it insanity; 44 of us stood up on the floor and kept saying it is insanity spending $35 billion for nothing. And, so, what happened? Three years later—they won the battle. We start building them; 3 years later, they all get up on the floor and say, "Enough is enough. We are just going to build 40, which is what we had already committed for." Finally, the President talked them into 50. So we are building 50 instead of 100. The problem is that the first 50 cost $25 billion—$25 billion for 50 missiles that do absolutely nothing for us, and here the farmers are all hanging by their thumbs. The deficit continuing to soar; and you couldn't kill one of those worthless weapons.

You know, I favor the Trident submarine; I favor the Trident II missile; and I favor the Pershing missile; I favor the Stealth bomber. But occasionally these systems come along like that and you just know at the belt buckle level that that's going to be very expensive and you can't kill it.

It has nothing to so with small business, which is what we are here to talk about. But that's my sermon on defense spending for today. You know, you try to kill them and people think you are against defense and you want the Russians to come up the Mississippi River and get us. All you are trying to do is get the biggest bang for the buck out of the money you're spending for defense.

Joe, what was a good statement, and I'm glad you pulled my trigger.

We try to keep these things informal and we are trying to hold these hearings because we think it's the very best of democracy to allow people to come in all over the States to express their opinion and not require them to come to Washington to say whatever they want to say.

We have a gentleman this morning who is from Marion named John Stephens. He's not a small businessman; he's retired. He used to be a farmer. But he wants to talk, and we are not going to try to stop anybody from talking.

Where is John? Come on up here and take a seat. I had a town-hall meeting in Marion, AR, not long ago and John was with us there. John, go ahead and tell us what's wrong with this country.

STATEMENT OF JOHN STEPHENS, RETIRED FARMER, MARION, AR

Mr. STEPHENS. What's wrong with this country?

Senator BUMPERS. Well, whatever you wanted to talk about.

Mr. STEPHENS. Well, the big thing that's on my mind, is bearing very heavily on my mind, is the $200 billion deficit and are we doing anything about it. Now, you just made a big statement about the defense, and I guess they carry their part of it, but that's not everything. Defense is not all that's responsible for the $200 billion deficit. And the total amount that this country owes is getting closer and closer every day to $2 trillion. How much does it lack being $2 trillion now?

Senator BUMPERS. About $150 billion.

Mr. STEPHENS. So it won't affect me. I'm 76 years old. What I'm worried about is the upcoming generations. You younger folks that are coming along here, that's what's got me worried. We concern ourselves about—well, to me looks like kind of minor things. What we need to do is get down here and get this deficit cut. Are we doing anything about waste in government? Senator, do you know about the Grace Commission Report?

Senator BUMPERS. You bet.

Mr. STEPHENS. Do you read that?

Senator BUMPERS. Yeah.

Mr. STEPHENS. Is anything being done about it?

Senator BUMPERS. John, about 30 percent of that has already been implemented, and the rest of it pretty much can be implemented by the President. It doesn't require any congressional action. The President can implement most of the things in the Grace Commission any time he wants to.

Mr. STEPHENS. Can't a committee of Senators go to the President and say, "Look here. We want the rest of the Grace Commission implemented." Can't you implement a program that would bring that about?

Senator BUMPERS. You could implement the whole thing, John. You really don't need the Grace Commission Report, though. You can adopt something like the Hollings-Chiles proposal this year and balance the budget in 3 years.

Mr. STEPHENS. What's got me worried—my whole interest is in farming. Here we are in an area—and I'm not critical of speaking in the interest of small businesses because we've got a lot of them—got a lot of friends that are in small businesses. We are in a farming area here and we hear all the time about the critical situation farmers face financially—and they are. They do face some serious situations.

The big thing that farmers are faced with as compared to business people, we are faced continuously with inflation. Oh, well, 4 percent inflation is not bad, but 4 percent last year, 4 percent this year, 4 percent next year. That all adds up to 12 percent. Now a small businessman can add this 12 percent onto whatever it costs him to do business and he can pass that along, but a farmer out here goes in to buy things that he operates his farm with, and that's added on to what that man—and you can't criticize him because he's got to stay in business—but the farmer can't add that on. Now, that inflation is what's killing the farmer. Now you're struggling with a farm program up there and you're struggling with a way to do something about solving the problem of farmers. I sympathize with you. I don't know how in the world you're going to do it, but the one thing—the big one thing that you can work on is controlling and getting at this deficit thing, which is a big factor in this inflation thing that's killing farmers.

Now, if you go back to Washington with that big thought in mind and get this deficit knocked down so that inflation will stop being—it will help not only the farmers but the generations that are coming along, and the whole country will benefit from it. That's the message that I have for you, Senator.

Senator BUMPERS. John, let me ask you a couple of questions. No. 1, I agree with you. I think the budget deficit is easily the single most important—maybe slightly under the fact that we keep building six nuclear warheads a day in the world and we have the ability to blow this planet out of orbit about 20 times, and that's probably the gravest threat hanging over us all the time and probably for all time to come. But certainly the budget deficit threatens the very economic survival of this country, in my opinion. Let me ask you this: The budget deficit in 1980 was $57 billion. How do you think it got to $220 billion?

Mr. STEPHENS. Just spending more than you're taking in.

Senator BUMPERS. That's the short answer. That's the obvious answer, but why that big jump from $57 billion to $220 billion?

Mr. STEPHENS. Well, you have just gone out and found ways to spend more and more money that you didn't have.

Senator BUMPERS. Well, the defense budget has gone from $145 billion to $300 billion. That's doubled in that period of time. Would you do anything about that?

Mr. STEPHENS. I believe I would. Of course, Senator, the defense budget is something that the average Joe out here is—he's awfully misinformed about. You, as a Senator, can very well be a lot better informed on that thing. We are going to have to lean on you in carrying the ball for us on that defense budget because there's so many things about it that's so far away that we can't see and we can't appreciate it.

Senator BUMPERS. Everybody is for a strong defense.

Mr. STEPHENS. I want to see the country defended.

Senator BUMPERS. We all do.

Mr. STEPHENS. And it's such a complicated world we're living in, and all these things that Russia has got over there to destroy us. Of course, we don't want to see it go down. At the same time, though, we've got people that will carry the thing to the extreme. You all have got your hands on the purse strings up there, haven't you?

Senator BUMPERS. When you say "you all," I have voted to balance the budget every year since 1981. And we just can't ever get the votes.

But let me ask you this: If it required not only a cut in spending but also raising taxes in order to balance the budget, would you do that?

Mr. STEPHENS. Yeah.

Senator BUMPERS. You would do whatever it takes.

Mr. STEPHENS. Whatever it takes because it's that important, as far as I'm concerned. This inflation thing is awfully important.

Senator BUMPERS. John, I want you to listen carefully to this now.

Mr. STEPHENS. All right.

Senator BUMPERS. There are 500 functions of Government—the Federal Government. That runs from immunizing children to educating children to food stamps to defense, Federal Bureau of Investigation, the Federal court system, the Coast Guard, you name it, Corps of Engineers to keep this river out here from flooding. Five hundred functions. Here are seven of them: Social Security, defense, interest on the national debt, civil service pensions, veterans' pensions, Medicare and Medicaid. That's seven functions.

Mr. STEPHENS. Are they the big ones in cost?

Senator BUMPERS. They are the big ones, but they're not the biggest. They are not necessarily the biggest. For example, Medicaid is not any more expensive than education, for example. But that's seven functions. If you eliminated the other 493 functions of Government. and you just financed those seven—take away all farm programs, soil conservation, ASCS, oil price support, everything for farmers—take away all those other 493 functions of Government, you still have almost a $100 billion deficit.

Mr. STEPHENS. Of course, I can appreciate the position you're in. There's hundreds of special interest groups that are knocking on your door every day in Washington. They are howling loud for their own little programs.

Senator BUMPERS. You're exactly right.

Mr. STEPHENS. Most of them are not very little.

Senator BUMPERS. That's right. They don't get it if they're little. If they are big, they get that special treatment they are asking for.

Mr. STEPHENS. That's right. Now, you've got all that pressure. You are under that tremendous pressure. I've given that a lot of consideration. You are human beings, and if I was up there in that shape, what would I do? Well, it's got to the point in time in this country looks to me like when enough of you Senators—there's 100 of you—are going to have to come together and say, "Now, look here, you special interest groups. We've got the interest of the country to save first. We've got to save this country." If you could mobilize enough of these Senators to do that—is that possible?

Senator BUMPERS. It hasn't been. but I'll give you another illustration. The President is red hot for a constitutional amendment to balance the budget. Now, No. 1, I am a real conservative when it comes to the Constitution of the United States. Next year we are going to celebrate the 200th year of the Constitution. John, it is that Constitution that allows you to come up here this morning and speak your piece. It gives us more freedom than any Nation on Earth has ever enjoyed. So when you start talking about tinkering with the Constitution, I don't care how you tinker with it, I belong in the "Wait Just A Minute Club." Because I think, next to the Holy Bible, it is the most sacred document to me.

But you know what it takes to put an amendment to the Constitution? I requires two-thirds vote of both the Senate and the House. You have to submit it to all the 50 States, and 75 percent of them have to approve it. You couldn't get a balanced budget amendment on the Constitution in less than 7 to 10 years to save your life. And the rate we're going, the budget deficit will be another $2 trillion in that length of time.

Incidentally, under the amendment the President proposes, 60 percent of both houses could agree to undo it any day they wanted to anyway.

Now, why do we want to go through this charade of requiring two-thirds of both Houses to approve a constitutional amendment and three-fourths of the States to approve a constitutional amendment when it only requires 51 Senators and 223 House Members any day of the year to balance the budget? I'll tell you why. Because it's great politics. You say, "Well, I'm voting for a constitutional amendment to balance the budget." You know what you ought to say to that Senator or that Congressman? "Why do you want to do something 10 years from now? Why don't you vote today to balance the budget? That's the right answer to that question.

Mr. STEPHENS. You are being real honest, Senator. Real honest.

Senator BUMPERS. John, you are a good witness. You're about the best witness we've had today. Appreciate your being here, and thank you all again.

The committee will adjourn.

[Whereupon the hearing adjourned.]

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